Montgomery's
AUDITING

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3

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PREFACE

In the last preceding edition of this book I pointed out that no profession stands still; it either goes forward or backward. In the eight years which have elapsed our profession has faced new responsibilities and gained increased recognition. In that period the Committee on Auditing Procedure of the American Institute of Accountants has issued no less than twenty statements on auditing procedure. It is true that many of these pronouncements dealt with problems brought about by the war; but many of them are of more permanent application. Through the statements issued by this committee and through the research bulletins of the Committee on Accounting Procedure our profession is reaching toward a fuller understanding of the standards under which we operate.

I have reviewed the first edition of this book which was published in 1912. I find that I then stated the prime purpose of auditing to be the discovery and disclosure of truth. I have consistently adhered to that belief. In practice we find it necessary to work under and apply standards, rules and practices which fit particular cases, all of which do not or should not affect our principles and certainly do not weaken our basic objective.

You may wonder why such a large proportion of this book, which after all is supposed to be a discussion of auditing, is devoted to accounting principles. The answer is that a knowledge of these principles is indispensable to the work of the auditor. The basic rules or conventions of general applicability in accounting are founded on a number of assumptions, as for example, that every enterprise will have perpetual existence. If our profession is to avoid stagnation it must keep alert to the necessity of re-examining these assumptions from time to time to establish their validity under current conditions.

In the field of medicine new techniques and new drugs are subject to critical analysis and proof before they are offered for general use. Court opinions define the law and corporate practices are established, altered or discarded to achieve conformity. In contrast, one of the handicaps of our profession is that it has no laboratory in which the new may be evaluated against the old—no facility which will produce conclusions sufficiently tested to *command* general acceptance, not alone by accountants but by businessmen. About as close as we have been able to come to accomplishing something of this sort is through the Committee on Accounting Procedure of the American Institute

of Accountants. In matters of accounting principles, this committee speaks for the profession. Nevertheless, the committee's authority is dependent upon the general acceptability of its opinions and the committee obviously cannot determine what does or does not conform to generally accepted accounting principles by waiting five or ten years after some idea is suggested to find out whether it will achieve acceptance.

Let me be perfectly clear—I have no complaint with either the way in which that committee functions or, generally, with its conclusions. In the nine years since its formation it has made notable contributions to accounting thinking and I have gone on record not once, but frequently, to that effect. My point is that we may need something else.

One of the basic assumptions of accounting is the stability of the dollar. It just isn't so! *We have a different dollar.* The dollars we used in expressing financial transactions in 1912 were pretty much the same kind of dollars as we had in 1932. Then came the deluge! Overnight we lost the gold standard and were handed a 59¢ dollar (which now sounds too good to be true).

Economists pretty generally agree that the diminishing value of the dollar has resulted in an overstatement of business profits. The word "overstatement" may not appeal to you any more than it does to me but I think we can agree on one thing—conventional reports of corporate profits under present conditions are highly susceptible of being misunderstood. This condition is rightly a matter of concern to accountants and businessmen who have the problem of reducing to dollars the results of a fixed fiscal period which has *two open ends.* The inventories, plant accounts and other items are fluctuating at the beginning and the end. It is impossible to restate dollar figures in the books simultaneously with fluctuations which may or may not retain their up or down course.

After more than eighteen months of consideration, the Committee on Accounting Procedure recently announced that it had reached the conclusion that:

> . . . . no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

In its release the committee said:

> The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to

meet it. It has solicited and considered hundreds of opinions on this subject expressed by businessmen, bankers, economists, labor leaders and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

I do not disagree with the committee's conclusion which I believe was the only decision it could have reached on the facts. However, as I have said on another occasion, good accounting practice and good business practice cannot remain long apart. Mere recognition of the problem is not enough. If there is a more satisfactory solution we must not regard the matter as disposed of until we have found it. In the meantime, as accountants, we have the responsibility of assisting our clients in every proper manner to interpret operating results so that they may not be misunderstood in the light of current conditions.

The effect of the diminishing value of the dollar on financial accounting has engaged the attention not only of the Committee on Accounting Procedure, but also of a group of businessmen, lawyers, economists, teachers of accounting and law, government representatives, comptrollers and practicing C.P.A.'s which was formed in the summer of 1947 to undertake a study of the nature of business income. I have followed the deliberations of this latter committee with a great deal of interest. A group of this sort might well provide the need, to which I have referred, of a research body which could remove the restrictions on creative thinking which adherence to "generally accepted accounting principles" now imposes. It is foolish to cling to accounting principles for no better reason than that they exist.

Recently financial writers have written much about and freely criticized our presentation of financial reports. It's old stuff and not as important as it sounds. If it were really important, there would have been more changes than have taken place in the thirty-seven years since the first edition of this book. I then said:

> . . . . A balance sheet in conventional form is perfectly clear to the eye trained to read and understand figures and is perhaps as concise and satisfactory an exhibit as could be desired *for the person who understands figures,* but thousands of businessmen frankly acknowledge that they do not grasp the full import of a financial statement in the accepted form.

> But if the man who is entitled to know all the facts contained in these balance sheets cannot or will not understand this method of presentation, is it not our duty to try another form and keep on trying until the results of his business become as interesting reading to him as the daily trade reports? If the client had his own way he would ask for a report on his business prepared so that he could read it.

There has been a trend (but not much of one) toward the narrative form of presentation. Well, on pages 3 to 6 of that first edition, I outlined a really good narrative and readable form of financial report. There can't be much demand for it or we would meet the demand.

Likewise, we are told to use more graphs, charts and comparative tables. On pages 230 to 237, I covered these in a manner so complete that I confess to a feeling of pride.

I doubt the practicality, or for that matter the desirability, of endeavoring to make financial statements clear to the uninformed. We are told that 90 per cent of the informed look only at net earnings, earnings per share and the comparisons with the preceding fiscal period. I therefore suggest that students in accounting courses take notice of the attempts, over a long period of years, of some of us to clarify financial statements and our inability to make more than a few changes in *form*. We have made much progress in disclosure and other important phases of *fact*.

Obviously no financial statements should be permitted to be issued which fail to disclose all material information regarding operations and financial position. Of less importance is the method of disclosure. In my opinion when *full* disclosure has been made of *all* pertinent information both the informed and uninformed should be able to get all they need. The uninformed will never understand but they have no basis for complaint. The informed get all they need and can form their own conclusions. Needless to say these conclusions differ widely.

The Securities and Exchange Commission has performed a notable service to the accounting profession, and to the informed public, in policing published financial statements. There is doubt in my mind regarding any substantial effect on the minds and actions of the uninformed. The viewpoint of the Commission was recently well expressed by Earle C. King, its Chief Accountant, who said:

> While the Commission has broad powers with respect to the determination of the accounting principles upon which financial statements filed with it shall be based—powers which to a large extent it has never exercised—it does not to my knowledge have the power, and most

certainly does not have any desire, to advise the investing public concerning the merits of any security.

It is imperative, therefore, that the Commission make certain that the financial statements contained in registration statements be completely unequivocal and are not used as a proving ground for innovational presentations.

This does not mean that we are against the adoption of new forms of presentation or the establishment of new accounting principles, should those presently in use prove to be outmoded. We do feel, however, that any major changes in basic principles or in the form or content of the income statement or the balance sheet should be made only after the entire accounting profession has given serious consideration thereto and is willing to endorse them without reservation or exception.

Over the years, my pet campaign (next to the trying to get pennies omitted from all published statements) has been to encourage the relegation of the mongrel term "capital surplus" to oblivion. The words were innocently joined together and maybe should not be called mongrels; nevertheless the term is appropriate, because it did not get the proper start. The word "mongrel" means "of mixed origin, character, or kinds," which seems to fit.

In hitching together two dissimilar words some years ago, we thought we were solving a problem. We did not anticipate the misunderstandings which have arisen. It is a sad fact that thousands of hours have been spent by our leading accountants in deciding where to debit or credit certain dollars. It was a great relief to me to hear that the Committee on Terminology has recently recommended abolition of the expression and endorsed the suggestion made in previous editions of this book that it be replaced in a given case by terms reasonably descriptive of its origin—now I can devote all of my energies to getting rid of those pennies! The loss in real value of the dollar has caused me to wonder just how worthless a penny must become to occasion more general acceptance of my suggestion.

It is a broad statement, but as this seventh edition is about to go to press, I say with confidence that there has been no change in thirty-seven years in the duties of the independent auditor. We continue to use our judgment in evaluating the honesty of our clients and adhere to our insistence on the disclosure of all important facts.

ROBERT H. MONTGOMERY

ACKNOWLEDGMENTS

One criterion of the vitality of any profession is the quality of its literature. Our profession has a right to be proud of its record. The broadening of our literature, while unquestionably beneficial, makes each succeeding revision of a book of this character increasingly difficult. The task would never have been accomplished except for assistance of many of our partners, among whom Prior Sinclair, C.P.A., Walter L. Schaffer, C.P.A., John C. Potter, C.P.A., Gustave F. Schweitzer, C.P.A., Donald P. Perry, C.P.A., Donald M. Russell, C.P.A., and George A. Hewitt, C.P.A., shared the responsibility of original preparation or critical review of much of the material. The research of accounting literature, the revision and arrangement of new material, and all preliminary editing was again under the able supervision of Gilbert R. Byrne, C.P.A., a member of the staff of our firm, who was assisted by Sidney B. Heywood, C.P.A., Edward J. Taylor, C.P.A., Arno R. Kassander, C.P.A., and Norman E. Auerbach, all members of the staff of our firm. The chapter, Procedure under the Federal Securities Acts, was prepared by Louis H. Rappaport, C.P.A., who, as a member of our staff, has specialized in that field for more than ten years.

R. H. M.
N. J. L.
A. R. J.

CONTENTS

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CHAPTER 1

SERVICES PERFORMED BY PUBLIC ACCOUNTANTS

This book is intended primarily for the practicing public accountant. Its discussions should also be of interest to business and credit men, bankers, analysts, labor union representatives, and those teaching and studying accounting.

In practice, a large part of the work of the public accountant is the examination of financial statements of business or other organizations, to enable him to give his opinion whether such statements present fairly the financial position and results of operations in accordance with generally accepted accounting principles consistently applied. Accordingly, a large portion of this book deals with the nature of financial statements, the accounting principles on which they are based, and the auditing procedures required to permit the expression of a well-founded independent opinion thereon by the public accountant. It is not feasible to describe all of the possible applications of accounting principles to the various situations with which the public accountant may be faced. Seldom, if ever, will he find it necessary to apply all of the auditing procedures described in this book in the examination of particular financial statements; and there will be many times when, because of the particular circumstances, he must devise different procedures to arrive at an opinion regarding the financial statements under examination.

Development of Public Accounting.—The present duties and professional standards of the public accountant are the result of the historical development of the profession, which has taken place, for the most part, within the memory of its present leaders. At the beginning of this century the public accountant's function was largely that of a staff department of business. Accounting, as an aid to management of business, was in its infancy. The public accountant,

as an expert in this field, was called upon to review the work of bookkeeping departments both as to proper application of accounting principles and as to accuracy of the work done. Business organizations were generally of medium size, and it was natural that management looked to the public accountant for much of the protection against fraud and error which today is afforded by adequate systems of internal control.

A number of factors have led to the development of public accounting. Public accountants themselves have educated businessmen to appreciate the importance of accurate bookkeeping. Technical improvements in the art have developed methods of internal control which have greatly narrowed areas of possible error and fraud. Management has realized that it has primary responsibility for the efficiency of and the results obtained by the accounting department just as for the production, sales, or other business functions. Growth in size of business units and in multiplicity of transactions has made impractical detailed checking by public accountants for discovery of mere bookkeeping errors. The federal income tax law, based largely on accounting determination of taxable net income, made the work of the accounting department of primary importance, for this tax is one of the heavy expenses of business. Public accountants have applied their knowledge of accounting and federal income tax practice to serving their clients in this field, and thus have enhanced their standing as professional accounting advisers.

The public accountant usually concluded his examination of the books and records with a report to his client of his opinion regarding the financial statements which had been prepared therefrom. Not only were such reports an assurance to the owners or managers of a business that the financial statements were reliable, but often they were required by financial institutions as a prerequisite for the granting of credit. Over the years this phase of his work has assumed even greater importance. Financing expanding business has required raising large amounts of capital, and the resulting diffusion of corporate ownership has brought into being large numbers of relatively small shareholders who are not intimately connected with management. This diffusion emphasized the necessity for an independent appraisal of the fairness of the reported results of management's stewardship as shown in the annual financial statements made available to shareholders. Fairness of financial statements depends upon proper application of principles of accounting, and it is natural that the opinion of the public accountant, as a professional expert in such matters, should be sought. Thus the public accountant's independent, objec-

tive, and impartial report upon his examination of financial statements has become his major function.

Services Performed by Public Accountants.

Independent Opinions on Financial Statements.—Independent opinions of public accountants are useful for a variety of purposes and to various groups. The professional attribute of independence, which is an important characteristic of the public accountant, is discussed and emphasized throughout this book.

Holders of securities of a corporation generally depend on periodic statements of the corporation's position and results of operations for information to assist them in deciding whether to retain, increase, or dispose of their investments. The advantage of an independent, expert review of the reports of management is generally recognized. Most well-conducted concerns, therefore, furnish to security holders, at least annually, financial statements accompanied by a report of independent public accountants. Other organizations, the financial needs of which are met through dues, donations, or taxes, such as clubs, labor organizations, charitable, religious and educational institutions, and governmental divisions, also find it desirable to submit, with their financial reports, the opinions of independent public accountants thereon.

With certain specified exceptions, corporations whose securities are listed on a national securities exchange must file financial statements, accompanied by a report of an independent public accountant, as part of the required initial registration statement and also as part of the succeeding annual reports required to be filed with the exchanges and the Securities and Exchange Commission. Corporations that register securities under the Securities Act of 1933 for sale to the public must have their financial statements certified by independent public accountants. After the securities have been sold, many of these companies must file annual reports, including certified financial statements, with the Commission as required by the Securities Exchange Act of 1934. A more detailed description of the accounting requirements under the 1933 and 1934 Acts is given in Chapter 22.

The New York Stock Exchange, effective in listing agreements made since July 1, 1933, requires that annual reports of listed companies to their stockholders (with few exceptions) shall be audited by independent public accountants and shall be accompanied by a copy of the certificate of these accountants. The current form of listing agreement between listed companies and the New York Curb

Exchange contains similar provisions. The New York Stock Exchange and certain other national securities exchanges require members doing any business with other than members and member firms to have annual audits by independent public accountants. The Securities and Exchange Commission requires that annual financial statements, certified by certified public accountants or public accountants, be filed with the Commission by most brokers or dealers in securities who are members of a national securities exchange.

Many bond indentures, preferred stock and note agreements require that financial statements be furnished at specified intervals, accompanied by a report of an independent public accountant.

Partnerships, especially those with inactive or limited partners, benefit when they have their financial statements examined and reported upon by independent public accountants. Regular examinations tend to minimize questions peculiar to that form of business organization arising under the provisions of the articles of partnership relating to salaries of partners, division of profits, or partners' overdrawings. The independent public accountant views such questions with impartiality and objectivity.

Bankers frequently require prospective borrowers to furnish financial statements accompanied by a report of an independent public accountant. This practice is becoming more general and the borrower who submits such a report is usually more highly regarded than one who does not. The extension of credit by the bank depends on the judgment of the loan officer as to the ability of the borrower to pay his loan when due, and such judgment can be more soundly based upon financial statements when they are certified by an independent public accountant. In addition, most bankers analyze financial statements of their borrowers for indications of business and management policies which the figures reflect. The public accountant, because of his experience and independence, is frequently better able to aid the banker in forming his judgment than is the prospective borrower, who rarely views without bias the condition of his own business.

Other Services to Clients.—Development of the work of the public accountant as an independent reporter upon financial statements has not led him to abandon the services in which the special interests of his client are foremost. Proprietors or managers of a business frequently find the work of the public accountant of significant value as a check on the work of their accounting staff. His tests of the operation of the system of internal control and of the accounting procedures, while not so detailed as in the early days of

the profession, enable him to form an opinion of the care exercised by the client's staff in keeping the records. When the auditor discovers loose methods or careless work he frequently is able to suggest changes in internal control or accounting procedures which minimize the possibilities of error or fraud in the accounts. Prevention is of far greater value than detection.

The public accountant is often consulted by his client on current accounting problems, relating both to methods and systems and to the proper application of accounting principles in recording transactions. The public accountant is well fitted to undertake surveys of a client's general accounting, budget, and cost procedures with a view to recommendations for improvement. While the client is responsible for the form and content of his published financial statements, the experience and expert knowledge of the public accountant enable him to suggest alternative acceptable presentations of data in financial statements.

The public accountant may be called upon to obtain and present data which will be considered in making a decision to buy or sell all or part of a business; he may be requested to express an independent opinion of the financial statements.

Public accountants have long been identified with service to their clients in income tax matters. Preparation of franchise, income and excess profits tax returns, advice upon tax effects of accounting transactions and representation of clients before taxing authorities are fields in which the public accountant has served his clients for many years.

The accounting provisions of contracts and leases, preferred stock, note and bond agreements or indentures, patent and license agreements, compensation and pension plans, corporate reorganizations, articles of copartnership, and agreements for the purchase or sale of all or part of a business are often referred to the public accountant for review and suggestion before adoption.

Businessmen have found periodic reports by public accountants of material aid in the adjustment of fire loss claims. The public accountant's investigation to determine the extent of losses covered by surety bond should furnish data for apportioning the total loss when different sureties are involved for different periods and may provide evidence on which recovery of excess losses from third parties may be based. Close cooperation between the public accountant and the bonding company is desirable in such examinations.

The public accountant sometimes is called upon to testify in court as an expert witness. Such testimony may be required when fraud

has been discovered and is to be proved, when there are facts to be established by accounting evidence, or when the public accountant's opinion is sought as to whether generally accepted accounting principles have been followed.

In the activities discussed in the preceding paragraphs there is stressed the service of the public accountant to his client. Even in services in which independence is not expected, the public accountant should maintain his objectivity, honesty, and integrity.

Services to the Public.—The accounting profession has been called upon with increasing frequency to perform public services for which its individual members are peculiarly well qualified by training and experience. Public accountants are active in charitable and public welfare groups in their communities and many take part in assisting or participating officially in local government functions. Others devote time to accounting education, as teachers or in an advisory capacity. Services rendered by public accountants in the fiscal and procurement branches of the armed services during both World Wars are well known. More recently, members of the profession have served or are serving on such governmental projects as the study of methods of simplification and promotion of economy in the federal government under former President Hoover and the study of the efficiency of the Bureau of Internal Revenue and the adequacy of its staff. Committees of the American Institute of Accountants have studied and reported upon improvements in the federal tax structure, and a group of certified public accountants has assisted the appropriations committees of Congress in studying budget requests. The profession has demonstrated its capacity and willingness to perform public services.

Classification of Audits.—The work of the independent public accountant in examining financial statements has long been referred to as an audit. Since the word "audit" is a general expression, there have been many attempts to classify the various activities of public accountants by descriptive terms, such as "detailed audit," "complete audit," "continuous audit," "test audit," "protective audit," "balance sheet audit," and others. None of these expressions has proved entirely satisfactory, although the term "balance sheet audit," referring to an examination as a result of which the public accountant is expected to state his opinion regarding the balance sheet and statements of income and surplus, is in common use.

It is logical to classify audits in two general divisions: (a) examinations for various purposes, as a result of which it is not

expected that the public accountant will state his opinion regarding the financial statements as a whole, and (b) examinations of financial statements to permit the public accountant to express his professional opinion whether they fairly state the financial position of a business at a given date and the results of its operations for a stated period, in conformity with generally accepted accounting principles consistently applied. The latter examinations must be conducted in accordance with auditing standards described hereafter in this book, but on occasion the standards may be exceeded by applying additional auditing procedures to accomplish some special purpose.

The Balance Sheet Audit.—This type of examination, described in (b) above, should be designed to give the public accountant reasonable grounds for belief that, except as otherwise noted:

1. All the assets shown in the balance sheet were owned by the client at the balance sheet date and were carried at amounts arrived at by application of generally accepted accounting principles;
2. There were no other assets of a material amount which were not, but which should have been, shown;
3. The liabilities shown in the balance sheet were actual or contingent liabilities;
4. All liabilities of material amounts are disclosed;
5. The nature of surplus is adequately disclosed;
6. The statements of income and surplus fairly present the results of operations;
7. The capital stock is properly classified and stated, and no stock of any class has been issued in excess of amounts duly authorized;
8. The financial statements as a whole, including the appended notes, do not include an untrue statement of a material fact or omit to state a material fact necessary to make the statements not misleading.

The term "balance sheet audit" is generally understood to derive from the fact that many auditing procedures are based on analysis of the difference between fairly stated opening and closing balances of an account as constituting the net change for the period. For example, substantiation of opening and closing inventories, accompanied by certain analyses or tests of the purchases and usage of inventory during the intervening period, is a basic audit procedure

for substantiating material elements of cost of sales which has stood the test of time. While the term has some relation to the basis of such audit techniques, there may be the unjustified inference that the examination does not adequately cover the statement of income, and that is not intended. The authors believe that the expression "balance sheet audit" should be avoided; up to this time a better one has not been suggested.

CHAPTER 2

AUDITING STANDARDS

The work of the independent public accountant is guided by one central, all-pervading purpose—to tell the truth about accounts. Years of experience have demonstrated that certain requirements are necessary to the attainment of this objective. These requirements are so important to the proper conduct of the work of the independent public accountant that they are properly referred to as auditing standards and in his formal report the auditor customarily states that his examination was made in accordance with generally accepted auditing standards.

Previous editions of this book have described in some detail all of the recognized auditing standards. Until recently, however, there has been no codification or summary statement of them. A statement of auditing standards was issued by the Committee on Auditing Procedure of the American Institute of Accountants in October, 1947. All practicing public accountants should be familiar with this statement, which is a fitting introduction to consideration of the work of a practicing public accountant. A brief summarization of its contents is contained in the following resolution which was adopted by the members present at the annual meeting of the American Institute of Accountants in September, 1948:

> Whereas, the committee on auditing procedure of the American Institute of Accountants in a special report *(Tentative Statement of Auditing Standards)* issued in October, 1947, among other things has stated that:
>
> "While it is not practicable, because of the wide variance of conditions encountered, to issue anything like an 'all-purpose' program of auditing procedures it is possible to formulate a pronouncement with regard to the auditing standards requiring observance by the accountant in his judgment exercise as to procedures selected and the extent of

the application of such procedures through selective testing." (Paragraph 6, page 7).

and that:

"Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon." (Part of the first paragraph, page 9)

and has presented the following brief summary of the meaning of generally accepted auditing standards (page 11):

"General Standards—

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

"Standards of Field Work—

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

"Standards of Reporting—

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Now Therefore be it Resolved, that:

(a) The foregoing excerpts from the committee's report are hereby approved and adopted,

(b) The use of "generally accepted auditing standards" in the reports or certificates of independent auditors shall be deemed to refer to the standards or principles set forth in the foregoing summary, and

(c) The references on pages 10 and 12 of *Extensions of Auditing Procedure* (Statement on Auditing Procedure No. 1) to the Institute's 1936 bulletin *Examination of Financial Statements* are no longer applicable.

General or Personal Standards.—General or personal standards relate to the qualifications of the auditor and the quality of his work. Generally accepted auditing procedures are those ordinarily employed by skilled accountants and those prescribed by authoritative bodies dealing with this subject, as, for example, the Committee on Auditing Procedure of the American Institute of Accountants. Only trained and experienced auditors can meet the exacting professional standards of auditing field work and reporting thereon. The auditor must be without bias toward the concern under audit since otherwise he would lack that impartiality necessary to the dependability of his findings, however excellent his technical proficiency. Proficiency and independence of thought, moreover, must be accompanied by due care in the performance of his work. In Chapter 3 the personal standards of the auditor are discussed in more detail.

Standards for Field Work.—In the performance of field work the auditor must keep in mind the elements of materiality and relative risk. The exercise of due care implies greater attention to the more important items in the financial statements than to those of less importance. The risk of error or fraud may be greater in certain areas and under certain conditions of internal control than in others.

In planning field work, timeliness and orderliness of application of auditing procedures are essential to due care in their performance. A knowledge of the system of internal control, gained by independent review, is essential to proper planning of the work. Based on tests of the effectiveness of the system in practice, the auditor exercises judgment as to the necessary extent of auditing procedures.

The bulk of the auditor's work in obtaining information upon which he may base his opinion is in the examination of accounting evidence. Internal evidence includes data within the client's organization. External evidence includes that obtained by inspection or

observation of physical assets, by confirmation from customers, creditors and other independent sources, and by specific inquiries. In his exercise of due care in the performance of field work the auditor should defer the determination of his auditing procedures until he has obtained an understanding of the available evidence and, of equal importance, formed some judgment as to its reliability. A general discussion of preparatory and administrative auditing procedures is given in Chapter 4, and in Chapter 5 the auditor's review and testing of internal control are covered.

Standards for Reporting.—The auditor's report is the medium through which he expresses his opinion on the financial statements subjected to his auditing procedures. Such financial statements comprise principally the balance sheet and the statement of income and surplus, and they are primarily the statements and the responsibility of the examinee.

The determination whether or not generally accepted accounting principles have been adhered to requires the exercise of judgment on the part of the independent public accountant, as well as knowledge as to what principles have found general acceptance, even though certain of these in application may have received only limited usage. Determination of consistency in application of accounting principles requires judgment as to whether a change is (a) the proper consequence of altered conditions, (b) a change to a procedure of definite preference in general practice from one not enjoying such preference, though both procedures may be acceptable, or (c) merely the choice, when two or more procedures are available, of an alternative dictated by ulterior motives, not by change of circumstances.

The final standard of reporting requires that informative disclosures, whether in the financial statements or in the auditor's report, be adequate to disclose the truth. Disclosures in the scope paragraph of the auditor's report usually deal with procedures omitted for some reason, but for which a satisfactory alternative procedure has been substituted; if such alternative procedure was not available, qualification may be required in the opinion paragraph. The auditor must consider the form, arrangement, and content of financial statements and appended notes and the adequacy of disclosure of material matters such as the bases of amounts set forth, liens on assets, preferred stock arrearages, restrictions on dividends, and contingent liabilities. In determining the adequacy of disclosure he must consider the terminology used, the details given, the sufficiency of explanatory or descriptive matter, and the classification of items in the statements.

The auditor may not express an opinion on financial statements if (a) for any reason procedures are omitted so that the auditor's examination has not been such as to afford him a basis for an informed opinion, or (b) his reservations or exceptions with respect to the financial statements are of such extent that they negative the expression of an opinion.

In Chapter 6 the auditor's professional standards applicable to his reporting upon his examination are discussed and illustrated.

CHAPTER 3

PROFESSIONAL STANDARDS AND RESPONSIBILITIES

The importance of the work of the public accountant in the conduct of business and in the maintenance and development of our economic structure is now generally recognized. The work demands specially trained men of the highest integrity and ability. The public accountant owes his client the duty, within the limitations of the scope of the particular engagement, to make his examination and report thereon with the care and caution proper to his calling. This chapter treats of the personal characteristics of the public accountant, his necessary qualifications, training and experience, and his relations with his clients, his fellow accountants, and the public.

Qualifications Desirable in the Public Accountant.—The man who wishes to become a useful member of the public accounting profession must have certain qualities; some of these are equally necessary to success in any field; others are peculiarly essential to the public accountant.

Character.—A man of character is, first of all, fundamentally honest. Honesty to the public accountant means that under all circumstances his work is conscientiously and carefully done; it means fearlessness in making distinctions between the relative merits of two or more courses of action and in advocating his decisions. Without scrupulous honesty in performing assigned tasks and in reporting the work done, at whatever level of responsibility, the public accountant cannot hope to measure up to the high requirements of his calling.

To the employee of a public accounting firm loyalty implies more than lip-service or outward obedience; it means subscription to the firm's ideals. It means acceptance of the judgment of those finally responsible, but carries the obligation to present all the facts as a basis for judgment. It requires that the employee devote his efforts to increasing his usefulness to the firm to the limit of his capacity. Loyalty is equally required of employer firm members and manifests itself by scrupulous fairness in all their dealings with their employees.

Capacity for Growth.—New demands are constantly being thrust upon the public accountant, resulting from constant changes in the problems and conduct of business. Only by constant study and alertness can the public accountant keep abreast of these demands, and his ability to serve his clients will be limited only by his own capacity for growth.

Analytical Ability.—The auditor who best accomplishes his task is able to put himself in the place of those for whom his report with its schedules and analyses is intended. Statements that are not clear to those who will receive them are unsatisfactory even though they may be free from material error; without a meeting of minds of the auditor and his client, ideal professional relations cannot be maintained. He should be able to analyze and interpret the facts behind the figures and to arrange them in such a manner that he can present intelligibly both the facts and his conclusions from them to those for whom the report is designed.

Constructive Ability.—The auditor should be more than an analyst. The proper presentation of all the material facts in financial statements requires imagination and constructive thinking, and the public accountant offers assistance in drafting them. Problems of business and their solution by management are reflected in the accounts; and the meaning of accounting results often must be interpreted to management by accountants. The interpretation of accounting data to those not technically trained in its use requires imagination and constructive ability of a high order.

Ability to Write and Speak.—Thorough training in the spoken and written use of the language by which he must convey his thoughts is of great importance to the public accountant. No matter how thoroughly he may do his work as an auditor, its value is greatly restricted unless he can report adequately upon the results of his efforts, both orally and in writing. An excellent method of gaining

skill in oral and written speech is to take part in the discussions in accountants' technical meetings and to contribute to accounting publications. Those who do so not only benefit themselves but help their profession by contributing to the growing body of accounting literature.

Objective Point of View.—The public accountant's viewpoint must be one of complete objectivity—detached, impersonal, and unprejudiced. This quality is related to the important attribute of independence, of which more will be said later, but it is as essential in the public accountant's work where independence is not required as it is when independence is a prerequisite.

Personal Attributes.—Self-reliance must be cultivated by the young auditor. He will not always be where he can ask for advice or instructions. Many times he must work out his own solutions to puzzling problems. He may make mistakes to be corrected by his superiors, but unless he displays initiative he will fail to develop self-confidence which begets confidence in him by others.

The public accountant often conducts correspondence or conferences with other people to arrive at agreements. It is important for him to be right in his positions, but it is of equal importance to be able to persuade others of the rightness of his views. Accordingly, tactfulness, the sense of what is appropriate to do or say in dealing with others without giving offense, is a very valuable attribute of the public accountant.

The possession and exercise of business sense is important to the auditor, not only in the conduct of his own affairs, but also in passing judgment upon the transactions of his clients and in counseling them with respect to their activities. Business sense, which means sound perception and reasoning as to a particular business transaction or the general conduct of a business, is sometimes intuitive but can usually be developed. Without it, an auditor's success will be limited.

Training and Experience.—The opportunities for education in public accounting are now abundant, thanks to the pioneering work of the leaders of the profession many years ago. Many leading universities, in their schools of business administration or commerce, give courses leading to a degree in accounting, and as preparation for the state examinations leading to the Certified Public Accountant certificate. In many schools graduate work in accounting is offered, leading to higher academic degrees. There are also a number of recognized schools specializing in accounting courses which are

accepted by certain states in which graduation from a school of accounting is a requisite for the C.P.A. certificate. Many of these schools and colleges maintain evening courses and extension courses so that the ambitious can pursue their studies while employed during the day.

Public accounting firms recognize that academic education must be supplemented with directed on-the-job training, and their staffs appreciate the necessity for instruction of their assistants as part of their daily work. Such training may be supplemented with periodic lectures on specific subjects and with firm bulletins or articles in regular house organs on matters of current interest. A number of firms hold regular classes over extended periods for groups of new employees, prior to their assuming staff duties.

Academic study is necessary, but the public accountant's value to his clients varies with practical experience. Only practical experience can give the public accountant the proper basis for making the innumerable decisions which are demanded of him during the course of any engagement. The extent of an examination, depending as it does on many factors, such as the nature of the engagement, the objectives to be attained, and the plan and effectiveness of the system of internal control, calls for the most experienced judgment. In the form and presentation of financial statements, also, no theoretical training can take the place of experience, and this is likewise true of the preparation of the public accountant's report.

In addition to thorough grounding in the principles of accounting and their application, and in auditing procedures which are effective under varying conditions, the public accountant should have a knowledge of business and tax laws. He must be familiar with various accounting systems to enable him to recommend improvements in the client's accounting procedures to provide more efficient operation, better internal control, or both. As determination of costs is important in most businesses, a knowledge of cost accounting and the various methods of arriving at costs is essential.

State Recognition of Public Accountants.—Each of the states and Alaska, Hawaii, the Philippines, Puerto Rico, and the District of Columbia have laws under which the public accountant who complies with certain educational and experience requirements and passes the required examination may style himself a "Certified Public Accountant." Every qualified person who intends to make public accountancy his life work should endeavor to obtain this certificate. It indicates his compliance with state standards for the practice of

his profession and makes him eligible to join one of the professional societies devoting themselves to the interests of the profession. Accountants who have not qualified as certified public accountants are licensed in some states as public accountants, registered accountants, or registered public accountants.

State and National Societies of Certified Public Accountants.—Certified public accountants have organized into societies in most jurisdictions granting the certificate and there is one national organization, the American Institute of Accountants. Each C.P.A. should affiliate with either his state society, the national organization, or both. The state societies and the American Institute of Accountants furnish continuing educational opportunities for their members through technical meetings at which current problems are discussed. The New York State Society of Certified Public Accountants, for example, has forty technical committees, appointed from specialists in their fields, from whom members may obtain advice on special problems. *The Journal of Accountancy,* published by the American Institute of Accountants, is the leading technical publication of the profession, and a number of the state societies have periodicals which are of outstanding merit in their field. The Institute and the state societies provide forums for the exchange of ideas and for the promotion and control of the growth of the profession. Through their publications and activities of their committees they interpret the aims and needs of the profession to the public.

Public accountants who have not qualified as certified public accountants have associations in many states and in 1945 established the National Society of Public Accountants.

Rules of Professional Conduct.—The American Institute of Accountants has adopted formal means for disciplining its members. A member may be admonished, suspended, or expelled by the Trial Board of the Institute if he infringes any of the Rules of Professional Conduct or if he is found guilty of an act discreditable to the profession. The Rules of Professional Conduct have been revised and expanded from time to time throughout the history of the Institute and are comparable to, and have the same objectives as, the rules of professional conduct of other professions such as medicine and law. They are designed to promote the interests of the public and the group interest of the members of the profession. A number of the rules aim to promote independence of the public accountant and are discussed later under that caption. The Rules of Professional Conduct are published in the year books of the Institute. They are dis-

cussed in "Professional Ethics of Public Accounting" (1946) by John L. Carey, Executive Director of the Institute.

The Committee on Professional Ethics of the Institute reviews complaints and inquiries arising under the Rules of Professional Conduct. Complaints are investigated and are usually discussed with the members complained against, and where the circumstances warrant the Committee recommends to the Executive Committee of the Institute that offending members be summoned for trial. A large part of the work of the Committee on Professional Ethics consists in advice to members whether proposed actions are permissible under the Rules of Professional Conduct.

Independence of the Public Accountant.—The professional public accountant offers clients his technical skill and knowledge based on his training and experience, but when he is retained to examine and render his opinion on financial statements, the value of his work rests even more upon his disinterested and objective viewpoint. Such a viewpoint can be consistently maintained only if the public accountant is truly independent in his attitude toward his clients and his work. Independence is a reflection of honesty and integrity. It is an inward quality, and not susceptible of objective determination or definition. Public accountants know that their reputation for independence and integrity is their principal asset, and they are impelled by enlightened self-interest, and supported by certain rules of professional conduct, to maintain their independence at all costs. Further discussion of independence of certified public accountants appears in Chapter 22.

Responsibilities of the Public Accountant.—It may be said that the primary obligation of the public accountant is to himself. As a professional man of honesty and integrity, he must perform his tasks with that care and skill which will satisfy his own high standards. In accepting engagements from his clients, he is obligated to complete each assignment with the knowledge that his best efforts have been expended regardless of the size or relative importance of the work or of the monetary profit to him.

The legal requirements as to the degree of skill and care expected of the public accountant in his work have been well expressed in the frequently quoted Cooley on Torts:[1]

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he pos-

[1] 4th Ed., Vol. 3, p. 335.

> sesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith or dishonesty, but not for losses consequent upon mere errors of judgment.

Responsibilities to Third Parties.—The public accountant has a legal responsibility to third parties, such as investors or creditors who have relied upon his report, but only if the errors or omissions therein are so grave as to constitute fraud. Mere negligence in the performance of his professional duties is not sufficient basis, ordinarily, to support a claim against the public accountant by third parties. But gross negligence may suffice to permit the inference of fraud. A court has held the following:[2]

> Accountants certifying a representation as true to knowledge of accountants when knowledge there is none, or making a reckless misstatement or an opinion based on grounds so flimsy as to lead to conclusion that there was no genuine belief in its truth or refusing to see the obvious or failing to investigate the doubtful, if sufficiently gross, are liable to third persons injured in their use of a certified balance sheet, even though there is lacking deliberate or active fraud.

In addition to his common-law liability, the independent public accountant who examines financial statements to be included, with his report thereon, in statements filed with the Securities and Exchange Commission, may be subject to statutory liability to third persons. This subject is discussed in Chapter 22.

Responsibilities Not Assumed.—The public accountant has a full-time job in following the profession of accountancy. He is not, and does not pretend to be, an engineer, an appraiser, or a lawyer. His work brings him into contact with many kinds of documents, stocks, bonds, notes, mortgages, checks, and the like, but he is not a handwriting expert nor an expert in forged documents. He may make suggestions to his client that the employment of members of other professions or specialists such as insurance brokers or traffic experts might be advisable, but the public accountant should not attempt to give advice outside his own field.

[2] 37 C.J.S., Fraud, Sec. 48, n. 90(2).

For Illegal or Improper Transactions.—Although the public accountant is not a lawyer, he is expected to be generally familiar with laws governing business and rules of regulatory commissions affecting the accounting of his clients. He is expected to use due care in the sampling and testing procedures employed to provide a reasonable ground for his opinion on the financial statements. The auditor cannot, however, be responsible for a policing program to see that all government regulations are followed. If, as a result of his tests, indications of what may be illegal transactions appear, and legal counsel agrees that illegal acts are involved, the public accountant should so report to the board of directors. He should also receive written opinion from legal counsel as to the liabilities of his client because of such transactions. If a substantial contingent liability exists because of illegal acts, the public accountant should insist that necessary reference to such liability be made in the financial statements, or qualify his opinion.

Through his usual audit procedures the public accountant may not discover improper payments such as excessive entertainment allowances, unless they are made in large amounts. If the public accountant finds that improper payments have been made, he should report them to the board of directors. If the board of directors approves these improper payments, the public accountant should receive a certified copy of minutes covering the approval. If the amount is material, he should also insist upon proper classification of the payments on the financial statements so that the reader will not be misled.

For Discovery of Fraud.—Even though experience has shown that most men are honest, including those in positions of trust in business organizations, the records of surety companies show that the minority who do steal from their employers are numerous and their peculations amount, in the aggregate, to large sums. The public accountant, with his heritage from the days when the discovery of defalcations was an important objective of an audit, always has in mind, in formulating a program for his examination of financial statements, the detection, and even more important, the prevention, of fraud. But the usual examination of financial statements, of which the only objective is to provide the public accountant with a sound basis for his opinion as to their fairness, is not designed to detect all kinds of fraud. It is conducted by tests which, by definition, means that large areas of the detailed transactions during a period are not checked by the auditor. Obviously errors may exist undetected and any error may be an innocent one or may conceal a fraud. It would

be entirely impractical for the present-day auditor to check all transactions of even a moderate-sized company because the cost would be out of proportion to any probable benefit to the client. Furthermore, the primary responsibility for the installation and maintenance of such a system of internal control as will minimize errors and fraud, lies with management; the public accountant's duty is not to substitute his responsibility for that of management, but to assist the management in meeting its responsibility. This does not mean that the usual examination of financial statements by public accountants is of no value in the prevention and detection of fraud; such examinations have over the years uncovered defalcations and peculations in large numbers. There is no way of knowing how many cases of fraud have been prevented, either because of fear that the auditor would discover the matter, or because the auditor has recommended procedures which made fraud difficult, but the number of such cases must be large.

The Public Accountant and Surety Companies.—In spite of a good system of internal control, established and maintained by the management which periodic examinations of the public accountants indicate is reasonably adequate and is functioning as designed, defalcations may still occur. Any system of internal control must be tailored to the circumstances of the business and, especially in small or medium-sized companies, the cost of maintaining a system so elaborate as to amount to a guaranty against fraud would probably be out of proportion to the risk of loss through defalcation. Public accountants generally recommend, as a third line of defense against fraud, the carrying of fidelity bonds on all employees, or at least on those occupying positions of trust. Adequate fidelity bond coverage not only assures recovery of losses from discovered defalcations, but it also has a preventive effect. The underwriter often investigates the past record of bonded employees and, as a result of notification to the employer, reduces the employment of persons of doubtful character. Employees may be deterred from theft knowing that bonding companies are much more likely to insist on prosecution than their employer, who might incline toward mercy.

In the past, however, a few bonding companies, under their rights of subrogation, have asserted claims against public accountants on the ground that all or part of the losses insured under a fidelity bond would not have occurred if the public accountant had made timely discovery of the theft. As has been stated many times, the auditing procedures in general use, which are designed to give the public

accountant a sound basis for an opinion on financial statements, are not intended to disclose all defalcations. If the public accountant is to be subjected to suits based on the theory that he is responsible for something which his examination was not intended to disclose, he might well conclude that he should protect himself by extending the scope of his examination beyond that which would ordinarily be necessary, with a resulting excessive cost to his client. Of course, any public accountant should be held responsible for an affirmatively dishonest act, or the willful failure to follow those audit procedures generally accepted as necessary to the avowed purpose of his examination.

Extension of audit procedures in an effort to disclose all defalcations would not serve the best interests of either the public accountant or his client. A committee of the American Institute of Accountants has explored the matter with representatives of a large number of surety companies, with the result that surety companies writing a high percentage of the fidelity bonds written in the United States have signed a letter, addressed to the Institute, in which they state that they will not assert claims against accountants in any cases not involving affirmatively dishonest or criminal acts or gross negligence on the part of accountants, and that claims shall in no case be asserted unless, after a hearing of the matter by an impartial committee of three persons who are not accountants, such committee concludes that the circumstances are such that the surety company may assert its claim. John L. Carey, Executive Director of the American Institute of Accountants, has said with respect to this agreement:

> It is hoped that other surety companies will participate in this general agreement which, it is believed, will help greatly to avoid unnecessary increase in the cost of audits, to encourage adequate fidelity bond coverage, and to bring about better integration of audit, internal control, and fidelity bonds as a defense against defalcation.

CHAPTER 4

AUDITING PROCEDURES—PREPARATORY AND ADMINISTRATIVE

This chapter continues a more detailed consideration of the Auditing Standards outlined in Chapter 2, particularly the Standards for Field Work having to do with adequate planning and supervision, and with the nature and procuring of evidential matter.

Planning Field Work.

Organization of the Public Accountant's Office.—Proper planning of an accounting engagement presupposes a proper organization of the public accountant's office and staff. In all human endeavor the larger the number of people required to accomplish its purposes the more exactly must the lines of responsibility and authority be defined. The requirement of modern far-flung business has fostered the growth of firms of accountants with hundreds of employees and numbers of offices in this country and abroad. Such

firms organize their work in such a way that each person is assigned to tasks for which he is fitted by temperament, training, and experience, and his work is supervised at each level by other persons of correspondingly higher capabilities. The number of levels are less but the same principles are followed by the public accountant who works with but one assistant.

The personnel of a firm with a number of staff members consists of partners, supervisors or managers, specialists, seniors, semi-seniors, and juniors; such a firm also has a report department and an office staff of clerical assistants, messengers, and telephone operators. Branch offices are under the supervision of resident partners or managers.

Every engagement should be under the general supervision of a partner or resident manager. A partner may take direct charge of some engagements and participate actively in the examination. Much of a partner's time is likely to be devoted to general guidance and review of audit programs and of the work done by members of the staff, consideration of the proper treatment of debatable matters, consultation with clients, writing of reports and opinions, and administration of the office.

Supervisors or managers may take charge of several engagements simultaneously. They may do little of the field work, but they plan the work, check on its progress, review the completed work, and review or prepare the report for a partner's consideration.

Seniors are qualified by training and experience to assume immediate charge of engagements in the field, to lay out work for semi-seniors and juniors, to direct their work, to pass upon many matters of practice or principle that arise in the course of an engagement, and to draft the report. In a particular engagement, a senior is directly responsible either to a supervisor or a partner. Many firms employ men who are specialists in taxes, cost accounting, installation of accounting systems, in some other phases of accounting work, or in government regulations such as those of wage and hour laws or of the Securities and Exchange Commission.

Responsibility for Work of the Staff.—In the final analysis, all of the work for clients by the partners and the staff of a public accounting office is the joint responsibility of the firm as a whole. The particular responsibility for each engagement falls on the partner who has general supervision over the work. The field work is usually the responsibility of the supervisor to whom the engagement is assigned and he, in turn, delegates certain parts of the work to the

senior and his assistants. At each of these levels of responsibility the principal must review the work of his assistants in order that informed judgment be reached both as to the adequacy of the audit procedures necessary in the circumstances and the integrity and clarity of the financial statements under examination.

ARRANGEMENTS WITH CLIENTS.—An important part of the preparatory planning for an engagement is to see that proper arrangements are made with the client.

Who Is the Client?—Uncertainty sometimes exists as to the actual client whom the auditor is serving, to whom he is responsible, and who will pay the bill. Instead of the person whose financial statements are under examination, it may be a banker or a prospective lender, a dissatisfied stockholder, a trustee in bankruptcy, petitioning creditors, a creditors' committee, a municipality, a congressional or an aldermanic committee, a state, or an investigating committee of the legislature. It is prudent, therefore, to determine in advance whom the public accountant is to regard as his principal.

Understanding of Purpose of Examination.—Most businessmen today understand the purposes and limitations of an audit leading to certification by a public accountant. Nevertheless there are some who do not, and the public accountant should make sure he understands what the client expects, particularly on entering upon a new engagement. If the client expects more than it is possible to give, the auditor should explain why his expectations cannot be fulfilled. The client may expect an unqualified opinion on his financial statements, but the circumstances may make impossible certain procedures which are necessary if an opinion is to be expressed. The client may expect that the examination will be so detailed as to amount to a guaranty against all defalcations and usually the auditor will wish to explain why such an examination would be impractical. On the other hand, unless the public accountant discusses the client's needs before starting the work, he may assume that an opinion is needed and proceed to do unnecessary work, only to find that the client has a different purpose in mind which does not require the expression of an opinion.

With Whom Arrangements Are to Be Made.—For many years arrangements for an audit were usually made with the auditor by a company official. More recently, to avoid any suggestion that the auditor's independence might be jeopardized, especially when the selection was made by the officer in charge of accounting, many com-

panies, particularly those with securities listed on a national stock exchange, have adopted the practice of having the independent public accountant selected by the shareholders at the annual meeting. Sometimes a committee of the board of directors, who are not officers of the company, is appointed to select and make arrangements with the auditors. The choice of the committee is frequently submitted to stockholders for their ratification.

Written Evidence of Arrangements.—Having reached an understanding with the client as to the purpose of the examination and who is to be responsible for the fee, it is prudent to confirm the arrangements made in writing, usually by an exchange of letters. When the auditors are selected by stockholders or by the board of directors it is customary formally to notify the auditors of the action. The following letter is an example of such notification, which clearly sets forth the understanding of the parties as to the work to be done:

(Name and address of certified public accountants)

Dear Sirs:

I hereby certify that the following is a true copy of resolutions adopted by the Board of Directors of (name of company) on (date).

After discussion, upon motion duly made, seconded and unanimously carried, it was

> RESOLVED, that (name of certified public accountants) be and hereby are appointed the auditors for the Company, with respect to its operations for the year———; and further
>
> RESOLVED, that such auditors be authorized and instructed to make such examinations, reviews, checks, tests and inquiries regarding the accounts, records, properties, business and affairs of the Company and its subsidiary companies as they may deem adequate, in accordance with generally accepted auditing standards, but without making a so-called detailed audit of the transactions, to the end that they may express their opinions as to whether the financial statements to be submitted to the Board of Directors and to the stockholders in the Annual Report for the year ———, together with any other financial statements from time to time issued by or on behalf of the Company which may be required to be examined by independent public accountants pursuant to regulations or order of any public authority having jurisdiction or pursuant to the instructions of the proper officers of the Company, fairly present the financial position of the Company and of its subsidiary companies and the results of their operations for the period or periods under review; and further
>
> RESOLVED, that such auditors be authorized and instructed to make such recommendations to the proper officers of the Company with re-

spect to the existing system of internal control of the Company and its subsidiary companies and with respect to the accounting methods used by such companies as from time to time appear to such auditors, as the result of the aforesaid reviews and examinations, to be desirable in the best interests of the Company; and that such auditors from time to time report to the Board of Directors any material recommendations so made; and further

RESOLVED, that such auditors be furnished by the Secretary with a certified copy of these resolutions, and that they be instructed to address their reports to the Board of Directors, or to send copies thereof promptly to the Board in cases where such reports are appropriately addressed to others.

(Name)

Secretary

When and Where Work Is to Be Done.—It is desirable that the appointment of independent public accountants to examine the financial statements of a concern be made as far in advance of the closing of the fiscal year as possible. This permits the auditor to become familiar with the client's business, to be consulted during the year on accounting problems, and to plan his examination so as to complete a substantial portion prior to the year end. In each of the chapters devoted to auditing procedures there will be indicated some of the work which normally can be accomplished in advance of the closing of the books. If it seems desirable that some portions of the work at various locations be done on a surprise basis, early appointment of the auditors facilitates the selection of locations and dates for this work.

Working conditions are just as important to the auditor's staff as to the client's personnel. But because the auditors are usually present for a comparatively limited time, adequate space, lighting, reasonable privacy, and access to books and records are not always provided. In the interests of efficient conduct of the examination, these matters should be discussed and proper arrangements made before the audit starts.

Use of Client's Staff.—The professional audit work of the public accountant is described by such words as check, vouch, test, scrutinize, analyze, review, compare; but the materials with which he works require clerical work such as the preparation of trial balances, lists, schedules, and obtaining from the files and arranging bank statements, vouchers, monthly statements, and tax returns. Even though the latter work would normally be assigned to junior accountants,

the cost when done by the auditor's staff is much higher than if done by the client's clerical force. Accordingly, the public accountant usually urges that as much of the purely clerical work of the audit as is possible be done by the client's regular accounting department staff. It requires nice judgment on the part of the public accountant to determine what he may properly require of the client's staff as being purely clerical and what it is essential that he do himself.

Preliminary Review of Work to Be Done.—There are a number of general matters on which the auditor needs information preliminary to beginning the examination.

Understanding the Type of Business.—During the auditor's early training he usually has an opportunity to become familiar with the general divisions of business—manufacturing, wholesaling, retailing, service business, banking and finance—and probably with some of the more specialized divisions of each. It is impossible, however, for any auditor to have experience in every kind of business, and engagements are sometimes accepted to examine financial statements of a business of which he has had no technical or special knowledge.

In any case, before commencing the examination the auditor should know how the business is conducted. No two businesses, even in the same field, are exactly alike and the auditor should never hesitate to ask all questions necessary to obtain a complete understanding of the special features of the particular business under review. If a manufacturing company, he will want to know about its products, the methods of manufacture and distribution, competitive position, selling and collection policies, and about many other features of the business. He should obtain an organization chart in order to know the lines of authority of the personnel with whom he is to deal.

Inspection of Plant and Premises.—A tour of inspection of the client's plant and offices before the actual audit work is started is desirable. The auditor has an opportunity to confirm visually the information gained orally about the plant, its products and manufacturing processes, and to meet many of the key personnel whose names he has seen on the organization chart. His later inquiry into the accounting procedures will have more meaning if he has a background of knowledge of the physical conditions of receiving, storing, and requisitioning materials and products and the conditions under which the basic factory records are produced. A tour of the offices will acquaint the auditor with the principal locations of the accounting and related work and with the size of the client's organization.

After the inspection trip is completed, it is well to summarize the knowledge gained for reference during the audit.

Location of Plants, Branches, and Subsidiaries.—It will often be found that the business of the client is handled at various locations. There may be several plants at which different products are manufactured. It is not unusual that district selling branches are established in various sections of the country, with local sales or service offices reporting to each district. When there are subsidiary companies, there may be similar dispersion of their operations at various geographical locations. The auditor must ascertain the location, function, and relative importance of each of the units of the company.

Review of Available Financial Statements.—An excellent starting point for any examination is to review the balance sheets and statements of income of the client for several past years and to obtain preliminary figures for the year or other period under review. This gives the auditor a good background of financial history of the enterprise and may give him an indication of what are likely to be the relatively important matters which will require consideration.

Opening Trial Balance.—In an initial engagement the auditor does not have the benefit of past knowledge of the company's affairs as a guide to whether accounting principles have been applied during the period under examination on a basis consistent with that of the prior period. The opening trial balance should therefore be obtained and studied, and the important items should be examined sufficiently to ascertain whether they are stated on bases comparable with the period or periods under review. If they are not, it is evident that even though the closing balances may be correct, the earnings for the intervening period cannot have been recorded on the books on the basis of a consistent application of the pertinent accounting principles. For example, if the inventory has been stated on one basis at the beginning of the period and on a materially different basis at the end of the period, the cost of sales as stated on the books for the period is obviously not computed on a basis consistent with that of the preceding year. Again, if the allowance for doubtful accounts was grossly inadequate at the beginning of the period and adequate at the end of the period, the operations of the period under review have been overcharged for bad debt allowances. The opening balances of prepayments and accrued expenses should be reviewed to determine the extent to which possible errors therein affect the income statement for the period under audit.

A comparison of the opening and closing trial balances is also helpful in that it may give the auditor an early clue as to asset and liability accounts that have been closed between balance sheet dates and may indicate other important changes in the accounts which would require consideration by the auditor.

In an initial engagement the auditor should also review the composition of the balances of capital stock, surplus, fixed or long-term liabilities, reserves, investments in fixed assets and securities, and deferred charges at the beginning of the audit period. The auditor is justified in limiting his examination for prior periods to a review or survey of the accounts mentioned without detailed examination, unless the results of his survey or analyses of those accounts reveal the need for further investigation of some of the major entries and the accounting methods that were followed in the prior years. Such documents as the articles of incorporation, by-laws, and minutes of meetings of board of directors and stockholders should be reviewed.

If the accounts of the concern have been examined for prior periods by reputable independent auditors, their reports should be read carefully and cognizance taken of the information they furnish. If the auditor has sufficient confidence in the ability of the predecessor independent auditors, he is warranted in reducing the scope of the review he would otherwise make of accounts and documents relating to prior periods.

Review of Ratios and Trends.—A review of comparative figures, actual and budgeted, ratios, and trends assists the auditor in planning his audit examination. It focuses attention on the important relationships in the accounts and helps him to form an opinion of the integrity of the financial statements. The gross profit ratio, ratios of inventory to sales and to cost of sales, and ratios of various items of expense to net sales are factors the auditor should consider in each engagement.

When a comparison of ratios over a period of years discloses an unusual variation in the period under audit, the auditor should seek an explanation of the causes of the variation. Unusual fluctuations may be caused by a change in the application of accounting principles, or they may result from errors or manipulations. Explanations he obtains may lead the auditor to extend his tentative plan of audit procedure.

Review of comparative figures and ratios often may uncover practices dictated by policies of the management as, for example, inconsistencies in providing allowances for depreciation, obsolescence, or

depletion; purchases and sales of commodities on speculation; unusual credit losses owing to a change in credit policy, or fluctuation in maintenance expenses resulting from change in policy of capitalization of certain expenditures.

Anticipation of Important Questions.—One of the purposes of the preliminary review of tentative financial statements, opening trial balance, prior audit reports, and comparison of figures and ratios is to raise at an early stage of the engagement questions which may require study, conference with the client, and decision. Often the client is under pressure to release preliminary year-end figures before completion of the audit, and it is of great practical importance to reach agreement on debatable points of accounting principles or statement presentation before preliminary figures are released. Review of interim figures per books, supplemented by questions addressed to the controller as to possible changes in accounting policy during the year, ordinarily will identify major matters needing clarification. This does not mean that any prescribed audit procedures should be omitted, but rather that those bearing on debatable points will be given priority in the audit time schedule.

Inquiry as to Basic Accounting Policies.—It has been suggested a number of times that each business enterprise, especially one having securities listed on a national stock exchange, should formally adopt, preferably by resolution of its board of directors, a statement of accounting policies which it intends to follow. There are advantages in this procedure from the point of view of the independent public accountant, but in practice it has seldom been adopted. Whether formally adopted or not, every corporation does have accounting policies which are reflected in its accounts and which often are described in manuals of accounting procedure. The auditor, therefore, should ascertain through inquiry and examination the client's accounting policies if he is to determine the consistency of their application.

Plant Additions, Repairs, and Replacements.—Proper differentiation, in practice, between plant additions, repairs, and replacements of plant is difficult. Consistent treatment of like items from year to year is essential and is difficult to attain unless precise regulations have been laid down. Some companies have a rule-of-thumb that items costing less than a certain sum shall be expensed, even though of relatively long life. Others customarily charge off all items of furniture and fixtures except the initial investment.

Cost of Inventories.—The general rule for pricing inventories is the lower of cost or market. But there are a number of permissible methods of determining both cost and market. These methods are discussed in Chapter 11. The auditor must ascertain which of the accepted methods has been adopted as the company's accounting policy. For example, as to costing of sales, the basis may be last-in, first-out, first-in, first-out, average, specific lot; as to the determination of production cost, all or only a portion of manufacturing overhead may be included.

Depreciation of Fixed Assets and Intangibles.—There are a number of acceptable methods of computing depreciation on fixed assets, and a number of variations in their application. There is perhaps even wider permissible variation in the amortization of intangible assets, especially those with no determinable life. The auditor must know the company's accounting policy in these respects.

Prepaid Expenses and Deferred Charges.—The company must determine its accounting policy for handling certain types of expenditure which benefit income of both current and future operations. There is frequently an option whether to charge an item to expense in the year in which incurred or to defer the charge, in whole or in part, to some future year or years. Whatever policy is adopted, assuming that the choice is a permissible one, should be consistently followed.

Year-End Cut-Off of Sales and Expenses.—The company may have adopted a policy of closing certain of its records, such as the sales book or the invoice register, a few days prior to the end of the fiscal year, to facilitate closing the books. If such early closing does not have a material effect upon the financial statements (and it seldom does), there is no objection to the practice, but it is one of which the auditor must have notice.

Review of Accounting Procedures.—In his preparation for an audit the accountant must also review the client's accounting procedures because they provide the basic data for implementing company policies and because they must be considered in determining auditing procedures and techniques to be employed. Accounting procedures may be said to include the plan and methods by which financial transactions are classified and recorded in the books of original entry and summarized in the ledgers; such procedures range from the chart of accounts and accounting manuals to the methods used in summarizing accounting data. Accounting procedures of a company provide some degree of internal control, but the purpose of a partic-

ular accounting procedure is to obtain a desired result as efficiently as possible; additional internal control may be needed to insure that safety is not sacrificed to efficiency. For example, the procedure of recording accounts payable transactions may be by accounts payable ledger or by voucher record; either method may be accompanied by a good or poor system of internal control.

Before even a tentative audit program can be drafted, the auditor must have a fairly complete knowledge of the major accounting procedures in use. Some of the alternatives which may be encountered are:

Control of all cash and accounts receivable may be centered at the head office, or each branch or factory may maintain its own records of cash receipts and disbursements, and sales and collections.

Inventory control accounts, supported by perpetual inventory records and tied-in cost accounts may be kept, or the accounting for inventory and cost of sales may depend on periodic physical inventories alone.

The cost system may be job, process, standard, or a combination of two or more of these.

Additions to and retirements from property accounts may be accumulated on job or work orders, or postings to classified accounts may be made directly from the underlying records.

There are many different accounting procedures for payment and distribution of invoices and pay rolls.

There are other features of the company's accounting procedures about which the public accountant will need to inquire before beginning his examination, but the above will serve to illustrate the necessity for information. It should be understood that the accounting procedures of a company affect mainly the *kind* of audit procedures or techniques to be followed; the *extent* to which audit procedures are applied depends upon other considerations which are discussed later in this chapter.

The auditor's method of inquiring into accounting procedures in the first instance is to ask questions of those responsible for the various sections of the work. He will usually record, in narrative form, the various steps said to be taken in recording each of the major classes of transactions. Such narrative will usually be illustrated with copies of forms used, and possibly with a flow-chart indicating the origin, routing, and final disposition of the several copies.

During the course of his examination, the auditor will confirm the information obtained; this is generally done by selecting a number of transactions in each category and following them through the records. He may trace items of cash receipts to deposits in the bank, receiving reports from the receiving department to the final resting places of the several copies, or invoices from the incoming mail to their final payment and filing. Such auditing methods ordinarily will provide assurance that the described accounting procedures are or are not actually in effect.

Audit Program.—There have been some attempts in the past to devise a standard or all-purpose audit program for the guidance of the senior accountant in charge of an engagement. Such attempts have always failed. Even though many audits have points of similarity, every public accountant realizes that different problems are encountered, not only in different businesses and in different companies in the same business, but also in any one company from year to year. Standard forms and standard directions are more likely to stifle vigilance, imagination, and independent thought and judgment than to promote good work.

An audit program designed for each engagement is a different matter. The authors believe that such programs are valuable because they:

1 provide a guide in arranging and distributing the work,
2 provide a check against the possibility of omissions,
3 facilitate control and review of work by partners and supervisors, and
4 provide a record of work done.

After completion of the preparatory work thus far described, the senior in charge of an engagement is in a position to draft a tentative audit program. This tentative program, based upon knowledge of the company's business, location of operating units, accounting policies and procedures, will be revised after reviewing the system of internal control. Further revisions may be required as tests indicate the extent to which the internal control is proved effective, and as the audit reveals areas which require further investigation. Even in recurring engagements, the audit program usually requires periodic revision either before the engagement is started or during the course of the work to fit changed circumstances resulting from changes in accounting or internal control procedures or in the character or volume of business.

Machine Bookkeeping.—It is not to be supposed that the machine age would leave bookkeepers untouched. On the contrary, the mass of daily transactions produced by present-day business has forced the invention and adoption of numerous mechanical accounting aids. Such aids are in general based upon the typewriter, the adding machine, the calculating machine, and the punch card. Numerous combinations have been devised for various bookkeeping purposes, and the punch card, originally used for the accumulation of statistical data, has progressed to the point where it is sometimes used to prepare consolidated financial statements. Each device has its advantages and disadvantages, and the present-day auditor will encounter all types frequently in his practice, and should be familiar with the principles of their operation.

The mechanics of machine bookkeeping affect the technique of auditing, but not the fundamentals of auditing procedure. When the auditor is faced with a machine-bookkeeping installation which produces, classifies, or summarizes any of the accounting data which find their way into financial statements, he must first thoroughly understand the way in which the machine operates. The best machines occasionally have mechanical failures; operators may make mistakes either deliberately or unintentionally. The auditor should know at what points errors may arise, how they are revealed mechanically, and how they are corrected.

Working Papers.—The professional public accountant devotes a great deal of thought to designing working papers for any engagement. They are instruments of his profession, produced anew for each job. Every engagement presents an opportunity to demonstrate the auditor's sense of orderliness and good methods, his skill in preparing papers which competently record pertinent information about the material under audit, and which provide cross checks not only as to the records under audit but also as to the auditor's own work.

The preparation and preservation of clear and effective working papers are important for the following reasons:

- they provide evidence of the extent of the auditor's work and of the care exercised in its accomplishment;
- they indicate the basis of conclusions and summarizations submitted in his report, and are a source of more detailed information which later may be requested; and
- they are a starting point for subsequent examinations.

Contents of Working Papers.—There are certain mechanical rules which should be followed in the preparation of working papers. Each sheet should be headed with the name of the client, the date of the examination, and the subject matter of the working paper. It should bear the date of preparation, and the names or initials of the staff members who prepared, checked, and reviewed the data. It should be clear, legible, and neat.

Trial Balance as a Basis for Audit Procedures.—The trial balance is usually the first working paper prepared, and frequently is used as an index of working papers. There are a number of ways of preparing the working paper trial balance, each of which has its advantages. Usually the trial balance is prepared in a form that compares the current figures with those of the previous year end. It is taken off in balance sheet and income statement order, and amounts are grouped into subtotals to permit ready identification of trial balance amounts with those on financial statements. Columns for post closing and auditor's adjustments are generally provided, which may be keyed to the supporting working papers.

Analyses and Schedules.—The working papers reflect the performance of the work prescribed by the audit program. They will include analyses of certain accounts, designed to show the transactions during the period under review, classified logically and displayed so that the tie-in with related accounts is apparent. Such analyses will also indicate by appropriate notation the work of the auditor in his examination of the account. There will be a record of tests made, such as footings of cash books, bank reconciliations, and detailed trial balances supporting controlling accounts, and memoranda of data upon which opinion is formed as to the basis or adequacy of certain items, such as the basis of stating inventory, plant, or investments, or the adequacy of valuation reserves or accruals. All checks, ticks, and other symbols used to indicate tests made should be clearly explained in the working papers. All material to be presented in the text and schedules of the report should be clearly supported in the working papers.

Most sets of working papers contain a permanent file which, carried forward from year to year, includes such relatively unchanging data as the certificate of incorporation, by-laws, bond and note indentures, contracts, notes on accounting policies and procedures, notes on organization, key personnel, location of plants, and such continuing material as the extracts from minutes of board of directors' meetings.

Data to Be Omitted.—The auditor should avoid the mere copying of data from the client's records. Copying is not substantiation. When the data are a part of the client's permanent record, a reference to the location is usually sufficient for the auditor's working papers. If the data are such that the auditor has a continuing need for them after leaving the client's office, it is often feasible to have copies prepared or photostats made for him.

Filing of Working Papers.—During the audit, working papers should be controlled so that ready reference may be made to the various matters in progress. Papers may be arranged by subjects in folders, or in loose-leaf binders with heavy separators and index tabs attached. Papers are best kept in the order in which they will be permanently filed.

Permanent filing of working papers is important because working papers are worthless if they cannot be found readily when need arises. Numerous methods of filing and indexing working papers are in use. One frequently found is to arrange the papers in the order of the items on the balance sheet and income statement or the trial balance, numbering the sheets as then arranged, and prefacing the set of papers thus filed with a carefully prepared index. Some auditors find it convenient to use the trial balance itself as an index, placing the numbers of the working papers opposite the trial balance items to which they apply. It is pointed out by the advocates of this procedure that the figures on the trial balance are a great aid for reference to particular items and the papers relating to them. A supplementary index, covering miscellaneous papers which cannot be directly identified with items on the trial balance, should be placed in the front of the set, if the trial balance itself is used as a general index. Whatever the method used, the important thing is the ease with which data can be found after the completion of the engagement.

After being arranged in the desired order, the working papers relative to a particular engagement should be bound. They should not be filed loose in an envelope for upon subsequent reference they easily become disarranged and cause the auditor unnecessary time and trouble in searching for the particular information he wants. There is the further danger that individual sheets removed will be replaced in the wrong envelope, or otherwise mislaid or lost. In binding working papers it is desirable that a heavy backing be used and that the cover contain, in addition to the name of the accountant or firm responsible for the work they represent, such information as the name of the client, the character of the engagement, the date or

period covered, and the names of the men engaged on the work. If the bound working papers are filed numerically, the file number should also be shown.

Storage of Working Papers.—Working papers relating to completed engagements should be filed alphabetically or given a number and arranged in numerical order in a fireproof cabinet or vault. For continuing engagements it is usually desirable to keep the last two or three years' papers in the public accountant's office for ready reference. Thereafter they may be transferred to fireproof public storage vaults.

It is probably never entirely safe to destroy audit working papers, as experience has shown that it has become necessary to refer to working papers many years after their preparation. There may be some circumstances in which the possibility of need for later reference is so remote that complete disposal is possible.

The storage of working papers of many clients over a number of years presents a difficult problem for the public accountant. Some public accountants have resorted to microfilming working papers after a certain period has elapsed; this permits reference to them, reduces materially the necessary storage space, and is a more permanent medium.

Ownership of Working Papers.—Since working papers are produced by the public accountant from information contained in books and records owned by his client, there has sometimes arisen the question as to ownership of these working papers. Based upon at least one legal case (*Ipswich Mills v. Dillon,* 260 Mass. 453), it appears that papers originating in the client's office, and loaned to the auditor, belong to the client; working papers prepared by the public accountant supporting his report to the client belong to the public accountant.

Accounting Evidence.—The bulk of the auditor's work in obtaining the facts upon which to base his opinion respecting the financial statements of his client is the examination of accounting evidence. The validity of accounting evidence is tested by the experience and judgment of the auditor.

Nature of Accounting Evidence.—Evidential matter of interest to the public accountant in the conduct of his examination of financial statements falls into two main categories; i.e., internal and external evidence. Internal evidence includes data available within the client's organization, such as the books of account, the various

subsidiary and detail records, the collateral memoranda and documents incidental to and supporting the recorded transactions, such as journal entries, checks, vouchers, invoices, bank statements, contracts, leases, correspondence, and minutes of meetings of directors and stockholders. External evidence is that which the auditor himself is able to obtain to corroborate the internal evidence. For example, he will confirm the existence of bank balances and securities in safekeeping by correspondence with the depositary or custodian; accounts receivable may be confirmed; securities on hand and inventory quantities may be inspected; liabilities may be confirmed by the creditor, and outstanding issues of capital stock may be confirmed by registrars and transfer agents.

Accounting Procedures and Accounting Evidence.—The auditor's knowledge of the client's accounting procedures will assist him in determining the types of supporting evidence which may be available for the asking. Explanations of the way in which certain transactions are handled in the accounts, and of the types and locations of the related records, will usually be obtained through questioning the client's staff. Experience has shown that this is one of the most difficult of the auditor's tasks; the clerks who are questioned are familiar with their own work, but frequently they are unfamiliar with correlated work of others. In their anxiety to cooperate with the auditor, they may supply him with information which they believe to be true but which is inaccurate. If the auditor is not careful in questioning his informers to assure himself that he has tapped a dependable source of information, he may find that he is depending on unreliable evidence.

Examination of Accounting Evidence.—The examination of supporting data should be made with a view to determining not only whether the evidence reflects and supports the transaction as recorded in the books of account, but also whether such evidence appears to be genuine. While the auditor is not an insurer against forgeries, he should see that documents apparently are authenticated by the signatures and approvals of persons authorized to sign, and that there has been no apparent alteration of dates, amounts, or approvals, which would cast doubt on the genuineness of the documents. He should ask himself whether in the light of all the circumstances, the transaction appears a reasonable one for the business under audit. The supporting data may often consist of schedules or computations such as those for tax accruals, bonus accruals, and certain types of inventories. It is important that the auditor verify the

arithmetical computations, but it is even more important that he understand and approve the basis of the calculation.

Extent of Examination of Accounting Evidence.—The sections of this book which describe the auditing procedures which may be appropriate in certain circumstances do not discuss the extent to which such procedures should be followed. Extent depends upon a number of general considerations. The purpose of applying a certain procedure has an important bearing on extent. For example, if the purpose is to ascertain whether a certain accounting procedure is followed as described, the tracing of a very few transactions should furnish the necessary assurance. If the purpose is to ascertain that company policy is being followed, for example, that established in distinguishing property additions from maintenance expense, a greater number of transactions should be reviewed. If the purpose is to consider the effectiveness of the system of internal control, a different approach will be made, as described in the following chapter.

Materiality and Relative Risk.—Materiality and relative risk are also important in determining the extent of auditing procedures.

It is a fundamental doctrine that there should be stronger grounds to sustain the auditor's opinion of relatively important items in the financial statements and those with possibilities of relatively material error than are required to sustain his opinion of items without these characteristics. Inventories of an industrial company are likely to vary from year to year and are of major importance because of relative size and the complexity of their accounting problems, whereas inventories of public utility companies vary less from year to year, are usually not material in amount, and present fewer questions of accounting principle. On the other hand, the plant accounts of public utility companies are important because of their relationship to the rate base, and therefore the public accountant will usually consider that his examination of plant additions and retirements of a public utility company requires greater attention than similar procedures for an industrial company. Seldom is the importance and possibility of material error in prepaid items and deferred charges so great as to warrant expanded audit procedures. The statement of income upon which the independent public accountant gives his opinion usually is not presented in such detail that errors of classification within major categories of income or expense would affect the figures given; extended audit procedures to disclose such errors, therefore, would not be justified.

While it should never be the sole consideration, the cost of audit procedures may properly be weighed as one of the factors to be taken into account in determining what is required, particularly when properly evaluated in relation to the elements of materiality and relative risk. In planning and carrying out his examination, the auditor is constantly exercising judgment whether, under all of the circumstances, he is justified in curtailing some of the contemplated detail procedures. He will do so only if he believes that there is but slight risk of material undetected error, which if discovered would affect his opinion of the financial statements. The auditor has a number of guides, based upon experience, which should lead to a sound decision. Examples of some of them are given below.

If a total is composed of a large number of small items there is less risk of material error than when the total is composed of a few large items. This is pertinent when considering audit procedures for substantiation of the large numbers of small accounts receivable of a public utility company as compared with relatively few accounts receivable of large amount of a manufacturing company. Supply inventories of a manufacturing company are often composed of large numbers of small cost items, and audit procedures usually can be safely curtailed for this portion of the inventory.

Cash and marketable securities, because of their mobility and convertibility, are more often the object of attention by defaulters than other assets. This fact is borne in mind by the auditor in framing his audit program. On the other hand, while of all assets, petty cash is probably most susceptible to peculation, the amount subject to this risk is usually small in relation to total assets and the auditor may properly devote a minimum of attention to this account.

The financial health of the business has a bearing on the degree of risk the auditor may safely assume. There is less pressure on the successful concern to window-dress, to minimize expenses and inflate sales, or to conceal liabilities. The auditor must consider that the newly organized business struggling for a foothold, or the established business fallen on hard times, may endeavor to postpone write-offs, adopt less conservative accounting policies, and conceal pledging of assets and creation of liabilities.

Finally, in his estimation of the permissible effect of relative risk on his audit procedures, the auditor will consider the plan and effectiveness of the company's system of internal control. The relationship of the degree of effectiveness of internal control with the risk of undetected error or fraud, and consequently upon the audit pro-

cedures of the public accountant, is so important that the next chapter of this book is entirely devoted to that subject.

The doctrine of materiality and relative risk tends to promote efficiency in the conduct of an audit. It insists upon proper attention to the important and encourages the exercise of judgment in eliminating or minimizing the unimportant. The auditor may properly reduce the extent of auditing procedures if the item under examination is not of material importance, because an undetected error would seldom affect materially the fairness of the financial statements or, if corrected, change the auditor's opinion.

Test-Checking the Evidence.—The auditing technique known as test-checking is based on the mathematically founded assumption that an analysis of representative samples of a group of items indicates the quality of the whole. The application of this technique has greatly influenced the present-day auditor's thinking about the necessary extent of application of audit procedures. By thoroughly checking all the items in a representative sample, the auditor may assume, under the mathematical laws of probability, that the number of errors found in the sample appears in the group as a whole in about the same proportion as in the sample. The auditor, therefore, has justifiably reduced the extent of his detail examination by the use of the test check or sampling method.

The basis of selection of the sample for test may vary. The auditor may check all items included in a specified period; he may check all the items over a certain minimum amount for the entire period; he may select a percentage of larger items and another percentage of smaller items; he may check a percentage of a total, either in dollars or number of items; or, in examining accounts filed alphabetically, he may select those under certain letters.

The bases of his tests should not be disclosed by the auditor to the client's employees, especially in annually recurring engagements. If they are disclosed, the employees may take care that the samples selected for test are free from error or indication of fraud, thus eliminating the value of the sample. The procedure of test-checking should be such that a dishonest employee may not be able to escape detection over a period of years by confining his manipulations to periods or classes of items which he knows will not be covered by the auditor.

The value of a test check as assurance to the auditor of the integrity of the records tested depends not only on judicious selection of items and a careful check of each one selected, but also on proper

consideration of errors or differences discovered. The errors so disclosed may not be important in themselves, but since they result from a sampling, they indicate possible important inaccuracies in the total. The auditor's procedure with respect to the errors generally should be to:

(a) Recheck the work to ascertain that the differences or errors are as indicated;

(b) Satisfy himself as to whether the errors are mere clerical mistakes, the result of an attempt to hide a defalcation, or the result of an attempt to misstate financial position or results of operations;

(c) Discuss the differences with the client, and determine whether the tests are to be carried further by the auditor or, if the errors appear to be merely clerical, by the client's staff, under the direction of the auditor;

(d) Reach a conclusion as to whether the aggregate error or difference is of sufficient importance to require adjustment of the accounts involved.

Within the limitation of the review decided upon in any year, the auditor's inquiries and tests should be searching and any deviation from prescribed policy or procedure, or from the client's professed routine of internal control, should be critically investigated. Records appearing too neat should be investigated to determine whether they have been written up all at one time, or whether or not they may represent original records rewritten with an ulterior motive. Any evidence of laxity on the part of any of the client's employees in matters of accounting or in the handling of moneys or other assets should be noted and called to the attention of some responsible official without undue delay.

CHAPTER 5

INTERNAL CONTROL

In the preceding chapter reference was made to an important auditing standard of field work—that the auditor shall have properly evaluated the client's system of internal control for the purpose of deciding (a) the appropriate auditing procedures and (b) the extent of the tests called for by such procedures. This chapter discusses internal control, the reasons for its emergence as a principal factor affecting audit procedures, its effect on the audit program, and the auditor's methods of investigating and test checking its operation.

Description.—Procedures of internal control are those which safeguard the assets of the company, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Management exercises control of all operations of the business. It determines its policies and makes its decisions largely on the basis of financial and statistical data furnished by the accounting department. It is of great importance, therefore, that such data be reliable.

There are many accounting methods and procedures which contribute to internal control. The chart of accounts should classify income and expense items so that comparison by periods will indicate to management conditions requiring attention. A properly installed and operated budget aids materially, and the value of a suitable cost system has been demonstrated. Statistical records of units of production and sales often provide an over-all check on operating results independent of books of account. In addition to these more general methods of internal control, the accounting department employs certain technical means to prevent errors in the periodic summariza-

tions of daily transactions and to minimize the possibility of erroneous or fraudulent dissipation of assets. Among such means are:

(a) Comparison of the total of debit categories (e.g., cash receipts) with the corresponding total of credit categories (e.g., credits to customers' accounts) when these have been prepared by different persons and through different media;

(b) Checking of prices, extensions, and footings of invoices, comparison of invoices with purchase orders and receiving reports, checking disbursements for plant additions, maintenance, and other expenses for proper authorizations.

In each chapter on auditing procedures a section is devoted to consideration of procedures of internal control applicable to the items covered in the chapter. It should be understood it is not expected that all of the suggested methods will be found in any one business organization. The necessity for and the importance of any specific internal control procedure will vary with conditions. Some suggested practices may at times be impractical, and others may cost more than they are worth. Good judgment again plays its part in tailoring the methods of internal control to the needs of a particular business or organization.

Development.—Every business organization has some form of internal control. The double-entry system of bookkeeping, which is almost universally used today, even by small concerns, is the first step in internal control. The one-man bookkeeper employs rudimentary internal control in using various techniques to prevent or disclose current errors. The proprietor of a small business knows about what the results of his efforts should be, and thus exercises internal control over the results as shown in the records kept by his bookkeeper.

Today there are many thousands of small businesses, but there are also many enterprises far greater in size than was thought possible fifty years ago. Increased size of business units required greatly expanded accounting, and the resulting division of labor made possible many cross checks, now a feature of the accounting department's internal control. Growth of business likewise made impractical one-man control based on intimate knowledge of current business, and forced companies to divide managerial responsibilities, and to measure managerial accomplishment by data produced in the accounting department. The necessity for good internal control in large business units has led to intensified study of its principles and prac-

tice, so that today even the smallest concern can employ methods and techniques formerly not available.

Internal Control and the Public Accountant.—In the early days of public accounting, most clients were small and there was comparatively little internal control. The chief service required of the public accountant by the owner-managers was to supplement their limited internal control with a competent outsider's check upon the accuracy of the records and to furnish reasonable assurance that the bookkeeper had not misappropriated funds. Under those circumstances, the public accountant's procedures necessarily included a rather detailed check of the available records. Because of the small size of the clients' organizations and the character of the work, the cost of those audits was not excessive.

Conditions have changed radically and these changes are reflected in the practice of public accounting. Now even in a moderate-sized company, the volume of transactions is so great that the cost of a detailed audit would be prohibitive. The more important consideration is that usually a detailed examination is no longer necessary, because effective internal control tends to prevent or minimize the possibility of error or fraud which the detailed examination was intended to expose.

The trend toward divorcement of ownership from management of business has had important effects. It has emphasized that the primary responsibility for the accuracy of the records of the business and for the protection of its assets lies with the management to whom the owners have delegated responsibility. They are primarily responsible for the installation and maintenance of a system of internal control, consistent with good standards applicable in the circumstances, that insures reasonable accuracy of the data upon which decisions are based and that prevents or promptly detects fraud or defalcation in the accounts. In the *Interstate Hosiery Mills* case (4 SEC 721) the Securities and Exchange Commission said:

> The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants however reputable. Accountant's certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.

The segregation of ownership from management has also led to the realization that the greatest value of an audit is the indeoendent

opinion expressed upon the financial statements by the public accountant. This portion of the public accountant's practice is today of far greater volume and of much greater significance to the public than his former role of expert bookkeeper.

In relinquishing the procedures of the detailed audit, and in assuming the responsibility for independent and professionally competent opinion upon the fairness of financial statements, the public accountant properly relies upon the system of internal control to insure reliable summaries of the transactions. Such reliance is justified because the public accountant:

- assumes responsibility for knowledge of the system in use, based upon personal investigation or inquiry;
- exercises judgment whether the system is reasonably designed to produce accurate summaries of the transactions, and minimize opportunities for fraud;
- makes sufficient tests to provide reasonable assurance that the system is in fact operating.

Internal Control and the Controller.—The officer charged with responsibility for accounting matters in most business organizations is the controller, although some other title is often used. As an important member of management, the controller shares in the formulation of policies and is in a position to advise, warn, and guide his fellow executives, to interpret the results of past policies, and to estimate the results of proposed policies or ventures. He is charged with implementing the responsibility of management for the accuracy of records and the protection of assets. He should remember that it is a personal responsibility as well as a responsibility of his office—in a famous fraud case the controller was convicted of complicity while two directors were acquitted. Most controllers appreciate that the public accountant's emphasis upon adequate internal control is for the protection of the controller as well as for the company.

Internal Control and the Internal Auditor.—As business expanded, the need was seen for centrally controlled policing of the accounting function of many organizations composed of numbers of dispersed units. This need is filled by the internal auditor's department, which is really a further development of the functions of the old-time traveling auditor, long a part of railroad and other accounting organizations.

The role of the internal auditor in business, while still developing, has won well-merited recognition. The Institute of Internal

Auditors Inc. was organized in 1941 to develop the status of internal auditing and provide a medium for the exchange of ideas. Its membership now exceeds one thousand in more than twenty chapters.

Usually the internal auditor reports to the chief accounting officer of the company, but sometimes he reports to the president, or even to the board of directors. He should not report to the individual who is directly responsible for the bookkeeping or accounting work. The work assigned to the internal auditor is an important element of internal control. It usually includes many of the auditing procedures followed by independent public accountants, such as physically testing inventories at factories and branches, confirming customers' accounts receivable and counting imprest funds at sales division offices, and making other tests, checks, analyses, and reconciliations at accounting centers. The internal auditor also acts as the direct representative of the controller to investigate and report whether prescribed accounting policies, procedures, methods, and routines are followed. His responsibilities often include investigation of company policy in other departments of the business—quite often as to credits and collections and general office management, and sometimes as to sales, advertising, and factory departments, especially as their activities produce records used by or useful to the accounting department.

The Internal Auditor and the Public Accountant.—Internal control is greatly strengthened by a well-operated internal auditing group. The independent public accountant relies on the work of the internal auditor on the same basis as he relies on other internal controls maintained by the client. He must ascertain what the program of the internal auditor is, he must exercise judgment as to whether it is designed to reveal errors and minimize fraud, and he must review the work sufficiently to assure himself that the internal auditors are following their prescribed program. This may be done by interview and by reviewing the audit working papers and the resulting reports of the internal auditors. The authors believe that the development of internal audit departments, not only in very large corporations but also in those of moderate size, is likely to continue and that this development will have a major effect on the practice of public accounting. The result may well be a shift of the burden of detailed checking of items and procedures from the public accountant to the internal auditor; this will relieve the public accountant of costly detail, and may further his position as an impartial adviser on matters of accounting technique and principle.

It should be understood that the internal auditor, while using many of the same auditing procedures as does the public accountant, does so from a quite different point of view. His duty is primarily to see that company accounting policy is followed. He is vitally interested in the cost of prescribed procedures, and in their effect on customers and company personnel, but he is less interested in whether they result in violation of accounting principle. The public accountant is interested primarily in the end results of accounting processes; the internal auditor, on the other hand, is interested primarily in the processes themselves. The public accountant will propose correction of errors disclosed by his examination; the internal auditor will try to prevent occurrence or recurrence of errors. In a word, he properly approaches his work from the point of view of management, and does not nor should he have the unbiased attitude of the independent public accountant.

Internal Control and the Audit Program.—The risk of error in the accounts and of fraudulent dissipation of assets is relatively less when the client has installed and is properly operating a good system of internal control. When his investigation of the system indicates that it is well-planned and effective in operation, the auditor properly takes this into consideration in planning the extent of his audit procedures. For example, when the auditor found, as he often did, that the cash book was the principal record of a business, that many transactions were made in cash, that bank statements were not customarily received and reconciled monthly, and that cash was received, deposited, and paid out by the same person who kept the general books and the detailed customers' ledgers, the risk of overlooking error or fraud was great unless he made a very detailed check of the transactions. But today such conditions are unusual and when the auditor encounters a client whose internal control of cash approaches that outlined in Chapter 8, the risk of error or fraud has been so reduced that it would be indefensible for the auditor to duplicate the work of the client's bookkeepers.

Over the years the degree and effectiveness of internal control as practiced by most companies has steadily increased. The old-time one-man business utilized internal control to a very limited extent, but the modern great corporations have highly developed systems. The inevitable effect has been to reduce the relative amount of detailed checking necessary to permit a well-founded opinion to be formed by the independent public accountant upon the fairness of financial statements. No two situations, however, are exactly alike.

Even the small business has some measure of internal control, perhaps all that could be reasonably expected in the circumstances. Even the largest corporations do not have perfect internal control and many of them have employees whose major assignment is to study ways and means of improvement. After the independent public accountant has reviewed the plan and effectiveness of internal control, it is his difficult task to exercise his best judgment to determine (a) what auditing procedures should be followed, and (b) in the light of the system of internal control, the extent to which they should be followed.

Internal Control and Discovery of Fraud.—Even when quite detailed audits are made, they may not be relied upon to disclose dishonesty involving collusion between highly placed personnel and outside persons. When less detailed audits are made, because of justifiable reliance on the system of internal control and under the doctrine of relative risk, there is inherent the possibility that undetected mistakes or errors are present. It has already been noted that the public accountant cannot guarantee to reveal all defalcations as a result of his usual examination of which the purpose is to give an opinion on financial statements.

Both the client and the independent public accountant rely in large measure on the system of internal control to insure accuracy in the compilation of transactions and as a protection against wrongdoers. No system, in practice, offers perfect defense against error and fraud, and the cost of a more elaborate system may be greater than the increased protection is worth. The public accountant, as an expert in accounting matters with experience in different situations, should be of service to his client in advising action to be taken respecting observed weaknesses in internal control.

Method of Investigation.—An important part of the work in the early stages of an audit is to determine what accounting procedures are followed, for this knowledge is important for the preliminary drafting of the audit program. In Chapter 4 reference was made to the usual method of recording the results of the review of accounting procedures in narrative form.

An equally important matter is the investigation of the system of internal control. Many accounting procedures furnish a measure of internal control, but a procedure which offers good protection against error may be accompanied by internal control which offers insufficient protection against fraud. For example, the comparison of duplicate deposit slips representing daily collections on accounts receivable

with the totals of postings to the customers' ledgers assures arithmetical accuracy, but there is internal control only if the employee who makes these comparisons does not also make the deposits.

Most of the information the auditor wants would be apparent from inspection of the records, but the time consumed in this way would be considerable. Direct inquiry of the person handling the matter is usually the most efficient method of obtaining the information. Before commencing his inquiries, the auditor must know what good internal control is.

The authors believe that a practical and useful device for investigating and recording the auditor's inquiries into the system of internal control is the standard questionnaire, prepared in advance for the use of staff members. Such a questionnaire, prepared by persons fully conversant with the problems of internal control, makes available to the staff auditor a large fund of accumulated experience, and furnishes a standard of comparison to measure the performance of the particular system under review. It furnishes assurance to the auditor that important matters are not overlooked. The questions can be framed so that a negative answer indicates a weakness in internal control that should be considered for its possible effect on the audit program. Also to be considered is possible discussion of such weakness with the client. Examples of questionnaires designed for use in evaluating the internal control of commercial and industrial companies, certain public utility companies, banks and trust companies, investment companies, and stock brokerage firms are given in the Appendix to this book.

Such questionnaires must not be used as a substitute for thinking, and must always be subject to revision to fit the needs of the particular client. Properly used, they provide the information upon which the public accountant can exercise judgment whether the system of internal control is reasonably designed, in the circumstances, to produce accurate summaries of the transactions, and to minimize opportunities for fraud.

Testing the System.—It is not enough that the auditor knows what the system of internal control is, and that he believes that it is adequate in the circumstances; he must also obtain reasonable assurance that the system as described is that actually in effect. This is the major purpose of the audit procedure of testing transactions for a period. Because of the nature of a great many of the routines followed, the basis for the auditor's belief that they are in fact followed is to retrace the steps taken by the company employees. It is usual

that certain clerks make arithmetical checks of invoices, see that proper documents are attached and that required approvals have been given. The only way for the auditor to reach an opinion whether these clerks have done these things is to recheck some of them. The presence of previously undetected errors indicates that the work was not properly done in the first place. To determine that petty cash vouchers are handled as prescribed, the auditor must review some of them. To ascertain that receipts are deposited daily and intact, the auditor must make some comparisons of the record of incoming remittances with the daily deposits. In short, the auditor must arrange his audit program so that during the course of his work he has followed procedures which will give him reasonable assurance of the accuracy of the answers to his questions about the system of internal control.

CHAPTER 6

THE SHORT-FORM REPORT

When as a result of his examination of financial statements the independent public accountant states his opinion regarding them, he usually presents what is generally referred to as a "short-form report" upon his examination. This report briefly describes the scope of the examination and states the auditor's opinion. The auditing standards governing the issuance of the independent auditor's report under these circumstances have been briefly described in Chapter 2 and are more fully discussed in the present chapter.

The wording of the independent auditor's report has had careful consideration by public accountants and other interested groups for many years, in order that it may convey to the reader the precise meaning intended in the circumstances. The present form, or framework upon which each report is built, was adopted by the American Institute of Accountants in September, 1948, and is used by the majority of independent public accountants. It is included in Statements of Auditing Procedure No. 24, issued in October, 1948, and is as follows:

> We have examined the balance sheet of X Company as of December 31, 19— and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It is not expected or intended that this form be used inflexibly; no form can be devised which, without alteration, can report the public accountant's findings on all of the different situations which he will encounter. The suggested form emphasizes that the report of the independent public accountant should (1) identify the financial statements under examination, (2) state the scope of his examination, and (3) state the auditor's opinion of the statements or the reasons why he cannot give one. The American Institute of Accountants first proposed a standard form of auditor's report in 1933; circumstances have since dictated several revisions.

Terminology.—For many years prior to the general adoption by independent public accountants of a standard form of auditor's report, it was usual to introduce the auditor's opinion with the phrase "we certify that, in our opinion, . . ." The auditor's opinion was quite naturally referred to as a "certificate," and it was common to say that he "certified" financial statements. Because of this long usage, these expressions are often heard today or seen in print.

The Institute's first standard form of auditor's report and its successors eliminated the words "we certify that," because the meaning is questionable and because the words might lead to an inference of exactitude which is not a characteristic of financial statements. The letter which accompanies the financial statements examined by independent public accountants is now usually entitled "Auditors' Report" or "Opinion of Independent Public Accountants," or other variations of these words. While these expressions are more exact, and are preferable in formal published reports to stockholders and others, the colloquial "certificate" is sufficiently understandable for informal use.

Contents of Short-Form Report.—The short-form report should be clear and concise; important limitations, exceptions, or explana-

tions must be stated in a manner that precludes misunderstanding or unintended implications. Unless otherwise stated, it may be presumed that the independent public accountant has done his work in accordance with generally accepted auditing standards, and details of the scope of an examination made in accordance with these standards need not be given in the short-form report. When such details are of interest, the auditor usually prepares a long-form report, which is the subject of Chapter 23.

Address of Report.—The auditor's report should be addressed to the client. The authors have already referred to the necessity for determining in advance the identity of the client, and have also pointed out that the public accountant's liability to his client is not the same as to third parties. Company officers, acting for the corporation, often arrange the details of the engagement with the public accountant, and the report is then addressed to the client company. When the independent public accountants are appointed by vote of the stockholders, or by the board of directors, the auditor's report is addressed to the body which has appointed him.

Date of Statements and Report.—The financial statements under examination bear the date of the balance sheet and the period or periods covered by the statements of income and surplus. The auditor's examination will necessarily continue for some time after the books are closed, so that the date of its conclusion will always be subsequent to the date of the statements. The auditor has some responsibility for inquiry about, and reporting upon, events occurring subsequent to the balance sheet date which materially affect the financial statements. This responsibility is considered more fully in the next chapter. Obviously the public accountant cannot have first-hand knowledge of these developments after the completion of his field work. His report cannot be dated before he has obtained all the data necessary for the proper formation of his opinion, and it should not be unduly delayed thereafter lest he be charged with knowledge of subsequent events which in the circumstances he could not have.

Signature of Report.—The usual practice of accounting firms is to sign their reports with the firm name without reference to the particular partner in charge. Occasionally a governmental commission or bureau requires, in addition to the firm name, the signature of an individual member of the firm. The auditor should observe these requirements when the occasion arises.

Variations in the Standard Form of Report.—The standard form of auditor's report can and should be altered to fit the circumstances. Variations are frequently necessary properly to identify the financial statements under examination, and sometimes the scope or opinion paragraphs require revision. Examples of more usual variations seen in practice are:

Identification of Financial Statements.—Not all examinations are made for a single company for a calendar year. Some organizations have established fiscal years ending on some date other than December 31st. The auditor's examination may cover a period of several years ending on a specified date. It is not uncommon that the financial statements are shown in comparative form, usually for two years, and the auditor's opinion may be worded so that it covers both balance sheets and both statements of income and surplus. Reports are sometimes worded to cover only the current financial statements even though the auditor has previously examined and reported upon the financial statements of prior year or years which are included in comparative form. Some auditors feel that having previously reported upon the prior statements it is not necessary again to report upon them even though such statements are shown in comparison with the current statements.

If the auditor's examination has covered a parent company and its subsidiary companies, the financial statements reported upon will usually show the consolidated position and consolidated results of operations. The opening sentence of the short-form report must be worded to identify the company (single or consolidated), the date or dates of the balance sheet, and the period or periods covered by the statements of income and surplus. If financial statements or schedules which are not covered by the independent public accountant's report are included in a report to stockholders or other published document, both the opening paragraph and the "opinion" paragraph of the auditor's report should identify the statements and schedules intended to be covered, by reference to titles, page numbers, or an accompanying index. In both paragraphs the descriptions of the financial statements should agree with the titles of the statements and schedules covered by his report.

Scope of Examination.—The portion of the standard form of auditor's report which briefly describes the examination is referred to as the "scope" paragraph. This paragraph is sometimes expanded by adding comments on the extent of examination of particular items such as cash, receivables, inventories, depreciation, or plant additions.

An objection to the expansion of the scope paragraph of the short-form report is that the selection of certain auditing procedures for comment may provoke unnecessary questions. The reader might wonder whether the mention of certain procedures implies that there is some unspecified significance which should have a bearing on his understanding of the statements; he might believe the omission to mention other procedures implies that they were not followed, and that he is expected to weigh the importance of this omission. Public accountants agree that they must assume the responsibility for determining the minimum scope of an examination. Because an expanded scope paragraph might, as stated above, be interpreted as an attempt to evade this responsibility, most public accountants believe that the present standard form of scope paragraph usually should not be expanded.

Reliance Upon Other Auditors.—It is not unusual for two or more firms of independent public accountants to collaborate in the examination of a large company with geographically scattered branches or subsidiaries. Rule Six of the Code of Ethics permits such collaboration between members of the American Institute of Accountants, a member of a similar association in a foreign country, or a certified public accountant of one of the states or territories, who may be presumed to maintain high standards. The arrangements between accounting firms which undertake specified portions of an engagement may differ according to circumstances, and the resulting auditor's report will usually reflect the arrangements made. Having accepted an engagement to examine the financial statements of a company with branches in various cities, the independent public accountant may engage another reliable auditor who is in good professional standing to examine a branch at a distant location. The second auditor may be the agent of the first, who may direct and review the work, pay the fee, and accept full responsibility. If so, the auditor's report need not refer to the other auditor, any more than specific mention would be made of a particular staff member or branch office.

Often there are reasons which make it desirable for the client to retain other auditors to examine the financial statements of domestic or foreign subsidiaries. The independent public accountant who is to report upon the consolidated financial statements will have no objection if the requirements of Rule Six are met. He should disclose in his report that he has not examined the financial statements of certain subsidiaries, but has received reports of other independent

public accountants, and that his opinion of the consolidated financial statements is based in part on such reports.

Other Variations in Short-Form Report.—Financial statements published by a company should be based upon the supporting data contained in its accounting records. Usually financial statements do not agree, item for item, with accounts shown on the books. Groupings and reclassifications frequently are necessary and various eliminations may be required in preparing consolidated statements. The public accountant who reports upon these financial statements may state wherein he disagrees, but he may not adjust the statements without the consent of the client. It is presumed that financial statements upon which the public accountant reports are compiled from the books, and it is not the custom in this country for the auditor so to state in his report. The authors believe it is the position of most independent public accountants that unless they receive all the information and explanations which they believe material to their purpose, they would not feel it possible to give an opinion at all, and therefore it is not necessary to assure the reader of their report that they did receive such information and explanations. In Canada and England, however, the laws regulating reports of Chartered Accountants require the statement that the financial statements are in accordance with the books of the company, and the auditor must also state whether he has obtained all the information and explanations he required. When auditors report upon financial statements which are to be used in Canada or England, there may be circumstances which make it desirable to recognize these requirements.

Meaning of "In Our Opinion."—The most important portion of the auditor's report is the opinion paragraph. It is here that the auditor distills all of the work of his examination and states what he thinks of the financial statements—whether they are fairly stated in accordance with generally accepted accounting principles consistently applied, or if not, why not. If he cannot give an opinion on the statements as a whole, the auditor should explain why. It is not always understood that the auditor's findings are primarily matters of opinion rather than statements of ascertained fact. They are the opinion of a trained, professional man acting without bias and with due care, but the auditor is seldom in the position of being able to guarantee that a statement is a statement of fact. He may state as a matter of fact that he has made an examination of the records of a company, but whether or not he has made an adequate examination under the circumstances or has seen all the significant records

is a matter of opinion. He might be able to state as a matter of fact that an attached statement is a true copy of another statement, but he cannot often state as a fact that a statement is as shown by the books of account because the fairness of the method of summarization from the accounts is also a matter of opinion. The auditor is not even safe in stating as a fact that he has examined the securities of a client and found them correct; for he can rarely, of his own knowledge, be absolutely certain that the securities are the property of the company, that they are bona fide securities and not forgeries, or that the record to which he has checked the securities is correct. He may feel reasonably sure of these matters, but in the last analysis they are matters regarding which he should express his opinion rather than his certain knowledge.

The phrase "in our opinion" should be made clearly applicable to all parts of the report which are intended as expressions of opinion. Violations of this rule are sometimes found in reports drafted in the amplified form. When comments in amplified reports relate to specific items such as inventories, depreciation, or plant additions, it is important that they be made subject to "our opinion" or phrases of similar meaning.

Meaning of "Generally Accepted Accounting Principles."—The customary opinion of the independent public accountant states that the financial statements under examination present fairly the position and results of operation of the business "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." Since this wording came into general use in 1934, accounting literature has been enriched by many discussions of what is meant by accounting principles. There have been a number of attempts by individuals and organizations to list them, but no list has met with unqualified acceptance.

The authors believe that there is now general agreement that the accounting principles referred to in the auditor's opinion are not those general principles which are defined as fundamental truths or comprehensive laws from which others are derived. There well may be such a body of fundamental concepts underlying the art of accounting, which do not change with fluctuations in business or economic conditions or different political philosophies. But such principles would necessarily be so broad that they would be of little use as a yardstick to measure comparability and consistency in preparation of financial statements. It has been necessary to develop over the years, in the application of the more general and fundamental princi-

ples of accounting to various situations which arise in practice, a large number of rules, conventions, and doctrines which authoritative writers and bodies have agreed are best calculated to present fairly the financial position and results of operations of business enterprises, in a manner most useful to owners, managers, and society, under the conditions then existing. Such are the rules, conventions, and doctrines which are referred to in the standard short-form auditor's report as "generally accepted accounting principles."

Authority for Generally Accepted Accounting Principles.—There are many sources which guide the public accountant in his search for applicable accounting principles when he is in doubt as to the right one to follow. He may refer to current published reports and prospectuses of corporations which are accompanied by the opinions of reputable accounting firms. He should be familiar with the extensive literature of accounting, in which accounting principles are expounded and discussed. The series of Accounting Research Bulletins of the Accounting Procedure Committee of the American Institute of Accountants offers a guide to generally accepted accounting principles on many controversial points, but until general acceptance of a particular bulletin becomes evident, it should not be regarded as having authority beyond that claimed for it. The Committee has indicated that "The authority of the bulletins rests upon the general acceptability of opinions so reached." The series of accounting releases of the Securities and Exchange Commission represents the views of the Commission, but these views are not necessarily expressions of generally accepted accounting principles. The reader will find that the succeeding chapters of this book contain sections dealing with what the authors believe are generally accepted accounting principles appropriate to the subject under discussion.

But accounting principles, it is well to emphasize, are constantly under review and revision under the cross-fire of practical experience and changing conditions. One has only to review the several editions of this book, starting in 1912, to find numerous examples of accounting principles (in the sense used herein) first advocated and later accepted generally by the profession; there are others which were thought to have great importance under different conditions but which are today not so considered. The comparatively short history of the Accounting Research Bulletins will show examples of the promulgation of rules which did not stand the test of time and experience. A past president of the American Institute of Accountants, Edward B. Wilcox, has spoken of the "tyranny of tradition," and

warned that too much order can lead to too little freedom. He has suggested that outmoded Research Bulletins and S. E. C. Accounting Releases be repealed, in order to demonstrate "both to ourselves and to others that we are not bound and fettered by everything that has been said, and that we will not slowly sink into a morass of outmoded accounting rules that usurp the place of judgment."

In the opinion of the authors, there will never be compiled one body of authoritative, exhaustive, and permanent accounting principles which the auditor may consult and compare with the practices of the company he is auditing. The reason is inherent in the nature of accounting, which must be capable of continuing adaptability to change and variation in business practices as well as to the economic background against which business is conducted. The application of accounting principles to the infinite variety of business situations is a matter for the judgment of the experienced accountant rather than for the mechanical application of a set of fixed rules.

General Acceptance.—The choice of the qualifying phrase "generally accepted" instead of "sound" in relation to accounting principles is based on two considerations: first, that an accounting principle which, after full discussion and development through experience, has been accepted by a majority of practicing accountants is sound because of that acceptance, with the corollary that minority opinion, if any, should give way to the majority under the democratic principle of majority rule; second, that general acceptance is a fact which can be objectively determined, and is more suitable as a criterion of proper use of an accounting principle than is its inherent soundness, which is necessarily a matter of opinion. When the Institute's Committee on Accounting Procedure chooses one of several alternatives as being in their opinion the proper accounting rule, the authors are willing to be bound by the majority decision as showing general acceptance, even though they may still believe one of the other alternatives is sounder practice.

General acceptance does not necessarily mean general practice. There are a number of accounting rules acceptable in particular circumstances which are not widely used, or are used primarily in certain industries. There are, for example, about forty technical committees of the New York State Society of Certified Public Accountants which deal with specialized problems of particular industries or businesses. A great deal of their work is advising practitioners of what, in their opinion, are the generally accepted principles of accounting to be applied to these situations.

Materiality.—Materiality is important to the auditor in his appraisal of whether financial statements are presented fairly in accordance with generally accepted accounting principles. The statements upon which the independent public accountant gives his opinion are expressed in figures, as well as in words. The auditor may believe that the client has adopted an accounting principle, general acceptance of which is doubtful; he may feel that the less desirable of alternative accounting principles has been used; but if the effect of the client's practice is not material in relation to the figures shown in the financial statements, there is usually no need for an exception in the auditor's report.

Consistency.—For the very reason that the choice between alternative accounting principles is flexible, depending upon the client's judgment, as concurred in by the independent accountant, consistency in application is of prime importance. It might make little difference in the total profits over a long period whether a long-term contractor computed his periodic profit and loss on a percentage-of-completion basis or completed contract basis. The two accounting principles might, however, produce noticeably different results *by periods,* and if one were followed in certain periods and the other in other periods, there is no proper basis for comparison. The consistency of application of accounting principles is of such importance, therefore, that it is a standard of reporting to state not only that generally accepted accounting principles have been applied, but that they have been applied on a basis consistent with that of the preceding year. Not every change in the application of accounting principles represents an inconsistency. A change in accounting principle may be the proper consequence of changed operating conditions or other governing circumstances. Whether a change is an inconsistency requiring comment in the auditor's report is a matter of opinion and involves the exercise of judgment on the part of the auditor.

A change in the application of accounting principles which does result in inconsistency is illustrated by recent revisions made by a number of companies in the costing of sales from the first-in, first-out basis to the last-in, first-out basis. Both bases are in accordance with generally accepted accounting principles, but a decision as to their relative usefulness in the particular circumstances and whether to change is the responsibility of management. The independent public accountant usually is obliged to point out such change in accounting principles applied, but usually he will not take exception to the propriety of the change.

A client may change from one acceptable accounting principle to another without the justification of changed conditions and without apparent benefits, other than seemingly more favorable showings of financial position or operating results. If the client insists upon making such a change, the independent public accountant is obliged to point out the inconsistent application of accounting principles, often to indicate the effect of the change, and he may express his disapproval thereof.

When there has been an inconsistency in the selection or application of an accounting principle, and whether or not the change is approved by the independent public accountant, the effect in dollars upon the comparability of financial statements before and after the change, if material, should be indicated by footnote.

Consistency and Comparability.—Usually inconsistent application of an accounting principle destroys proper comparability of financial statements. It is possible that a change may be instituted at a time when the effect of the change upon the current financial statements is small, but the effect in the future may be material. For example, the change from the Fifo to the Lifo basis of costing sales and inventory may be made when the effect is negligible, but when there is reasonable certainty that the effect in the future will be material. In such circumstances disclosure of the change should be made.

Accounting Research Bulletin No. 6 states as a well-recognized rule that "any change in practice which would affect comparability should be disclosed." Most auditors believe that changes in classification which materially affect comparability of corresponding items in financial statements, whether in the balance sheet or the statement of income, should be described in a footnote. It does not follow that an exception as to consistency in the application of accounting principles need be taken in the auditor's report.

Statements may lack comparability even though consistency in accounting principles has been maintained. A subsidiary, consolidated at one date because it was controlled through majority stock ownership, may not be consolidated the following year because control was relinquished by sale of a substantial block of stock. There is no inconsistency of accounting principle, but attention may be called to the lack of comparability by footnote. In Bulletin No. 22 issued in May, 1944, the Committee on Terminology of the American Institute of Accountants cited two different treatments of liability for renegotiation, one of which was proper under the circumstances

existing at the close of 1942 and the other was proper at the close of 1943, resulting in noncomparable financial statements for those two years. The committee noted that no inconsistency was involved either in accounting principle or manner of application; it raised the question whether noncomparability required disclosure.

The test of materiality is applicable to questions of disclosure of inconsistencies and noncomparability. If the change, whether in accounting principles, their application, or merely of classification, does not materially affect proper comparability of the financial statements of one year with those of the preceding year, the change need not be disclosed, unless the conditions are as cited in the first paragraph of this section.

Rule 5 of the Rules of Professional Conduct.—This rule of the American Institute of Accountants is not only important as a reinforcement of the independence of the public accountant; it is also a requirement that members of the Institute in their capacity as independent auditors must be governed by generally accepted accounting principles and do their work in accordance with generally accepted auditing procedures applicable in the circumstances. A member or associate may be admonished, suspended, or expelled if he infringes any of the Rules of Professional Conduct or if he is found guilty of an act discreditable to the profession. Rule 5 describes some of the acts discreditable to the profession and must be considered in determining the public accountant's responsibilities for the short-form report. It is appropriate to quote it in full.

> In expressing an opinion on representations in financial statements which he has examined, a member shall be held guilty of an act discreditable to the profession if:
>
> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
>
> (b) He fails to report any material misstatement known to him to appear in the financial statement; or
>
> (c) He is grossly negligent in the conduct of his examination or in making his report thereon; or
>
> (d) He fails to acquire sufficient information to warrant the expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
>
> (e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedures applicable in the circumstances.

Qualifications and Explanations in Short-Form Reports.—The standard form of short-form report so far discussed, with suitable variations to fit the circumstances, may be used when the auditor is prepared to give his opinion without qualification either as to scope of his examination or as to fairness or consistency of application of generally accepted accounting principles. There are two additional classifications of short-form reports: one in which the independent public accountant is precluded from expressing an opinion upon the financial statements as a whole, and the other in which he states his opinion with qualifications.

Nugatory Opinions.—The independent public accountant forms his opinion of financial statements based upon the examination which he makes of them. If his examination has been restricted in any important respect, either by the client or by circumstances, it follows that he cannot have that knowledge of the facts which is necessary for a soundly based opinion. His reservations or exceptions with respect to the fair presentation of the financial statements in conformity with consistent application of generally accepted accounting principles may be so material that they negative the expression of an opinion. When the public accountant is faced with one of these conditions, Statement No. 23 of the Committee on Auditing Procedure issued in December, 1947, states that:

> In such circumstances, the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor. He may also, if appropriate, comment further as to compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion.

The following is an example of a report which might be made by the independent public accountant when he has made an examination of a satisfactory scope in all respects save one—and that a material one—but does have an opinion as to the financial statements in other respects:

> . . . . We did not observe the taking of the inventory amounting to \$. . . . . at the . . . . plant, nor are the inventory records at that plant such that it is practicable for us to satisfy ourselves as to such inventory by alternative auditing procedures. In all other respects our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

> Owing to the limited scope of our examination with respect to inventories we are unable to express an opinion as to the fairness of the accompanying financial statements as a whole. In all other material respects, in our opinion, the accompanying financial statements present fairly the assets (other than inventories at the .... plant), liabilities and capital of the Blank Company at December 31, 1948, and the income, costs (other than such costs as may be affected by possible misstatement of the inventory at the .... plant) and expenses for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

If there is a material uncertainty with respect to an asset, a liability, or a contingency, the auditor may be unable to express an opinion, even a limited or qualified one, upon the financial statements as a whole. An example of the opinion paragraph of a report, where the auditor was unable to express a limited or a qualified opinion, is as follows:

> In our opinion, the financial position at December 31, 1948 of the Blank Company and the results of its operations for the year then ended cannot be presented fairly until the contingency, described in Note — to the accompanying financial statements, has been resolved within reasonable limits.

QUALIFICATIONS OF AUDITOR'S OPINION IN SHORT-FORM REPORTS.—The independent public accountant issues his report with a qualified opinion if his exceptions are not so material as to negative his opinion, and if the client cannot be persuaded to accept the auditor's view on a disputed point. Most businessmen listen to sound arguments before the financial statements are prepared, and frequently it is possible to effect changes in the statements which will permit the auditor to give an unqualified opinion. But when qualification is necessary, it must appear in the auditor's report without fear or favor; it must be couched in clear language and be stated as specifically as conditions warrant. Qualifications may relate to the scope of the examination, to the accounting principles applied, to the consistency of their application, or to uncertainty of position.

Scope of Examination.—There are some circumstances in which the independent public accountant may properly state his opinion of financial statements when the scope is not so limited as to negate an opinion on the statements as a whole, even though it differs from that usually considered necessary. He should, however, explain the deviations and indicate an exception in the scope paragraph of his report

as well as in the opinion paragraph. Some examples of auditor's reports which are qualified in these respects are given below.

Deferment to Opinion of Another Authority.

. . . . Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except that the existence and appraised market values of precious stones were established by independent appraisers, and our examination of such inventory was limited to substantiation of the cost of the stones stated by the appraisers to represent the inventory.

In our opinion, based upon our examination and, as to the existence and appraised value of the inventory of precious stones, upon the determinations of independent appraisers, the accompanying balance sheet . . . .

Impracticality of Substantiation.

. . . . While summaries and detailed listings of inventories at December 31, 1947 are available, the accounting evidence supporting such listings as, for example, the bin tags upon which original notations of counts were made, and the tabulating machine cards from which the lists were prepared, cannot be located. It is our opinion that there is no feasible method by which we may at this date independently substantiate the inventory amounts at the beginning of the year 1948. With this exception, our examination was made in accordance with generally accepted auditing standards and included such tests of the accounting records and such auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet fairly presents the financial position of X Company at December 31, 1948 in conformity with generally accepted accounting principles. Our inability to substantiate inventories at the beginning of the year 1948 precludes us from expressing an opinion as to the results of operations for the year. In all other material respects, in our opinion, the accompanying statement of income presents fairly the income, costs (except cost of sales) and expenses for the year in conformity with generally accepted accounting principles.

Omitted Procedures for Other Reasons. There are instances of omission of audit procedures which under usual circumstances would have been employed by the public accountant. There may be reasons why the client feels it would be disadvantageous for the auditor to request confirmations of certain types of assets or liabilities.

There have been instances where the books of account covering early years of a company have been lost, and the auditor therefore cannot review all of the history of the plant accounts, capital stock, and surplus. The auditor may be able to use alternative audit procedures as the result of which he may conclude that the risk of material error is small. He may, however, feel that his opinion requires qualification, as in the following:

> . . . . Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except that on request of the company we did not confirm investment securities included in the balance sheet in the amount of $50,000 which were stated to be held by the State Insurance Commission. In our opinion, subject to the exception that we did not confirm the securities mentioned in the preceding paragraph, the accompanying balance sheet . . . .

Disagreement with Client as to Accounting Principle.—The second general class of qualifications arises when the independent public accountant and his client cannot agree as to whether the financial statements have been presented in conformity with generally accepted accounting principles, or when the client has effected a change in accounting principle, resulting in an inconsistency in application, of which the independent public accountant does not approve.

The short-form report which expresses a disagreement as to accounting principle will usually include a paragraph immediately after the scope paragraph in which the point at issue is described, or reference is made to the appropriate section of the statements. The opinion paragraph then expresses the auditor's qualifications, as in the following:

> Inventories at December 31, 1948 are stated at cost which was $40,000 in excess of market. In our opinion, generally accepted accounting principles require that inventories be stated at the lower of cost or market which was the basis used at December 31, 1947.
>
> Except as stated in the preceding paragraph, in our opinion, the accompanying balance sheet . . . .

Disapproval of Change in Accounting Principle.—When the independent public accountant does not agree that a change in an accounting principle or in the method of its application is proper, he should so state. Whether he should also qualify his opinion as to the fairness of the financial statements depends on whether the effect of the

change is material. An opinion paragraph which is appropriate when the change is material, follows:

> Except for the change in the method of recording accrued premium income described in Note 1, which change we do not approve, in our opinion, the accompanying balance sheet . . . .

Uncertainty as to Position.—Although there may be complete agreement between the client and the independent public accountant as to the facts, the latter may feel it necessary to qualify his opinion of financial statements. This may occur when the position of the company is uncertain because of an unresolved question of contingent liability which is not so material as to negate the expression of an opinion on the financial statements as a whole. A common example is the liability for federal income taxes, when there is a controversy between the client and the Treasury Department involving substantial sums. The financial statements include a provision for the liability for taxes deemed proper by the client, and the basis of the controversy is explained in a footnote. Neither the client nor the auditor can be sure what the liability as finally determined will be, although limits of the uncertainty may be computed. In other words, the client and auditor agree that the position of the company is uncertain with respect to a substantial amount of liability. Many independent public accountants in these circumstances feel that their opinion of the financial statements can be no more certain than the client's, as expressed in the footnote, and therefore would qualify their opinion somewhat as follows:

> Except for such additional provision, if any, for federal taxes on income as may be required upon final examination of the company's tax liability (see Note —), in our opinion, the accompanying balance sheet . . . .

Explanations in Short-Form Reports.—There are some types of data which occasionally are necessary in the short-form report of the independent public accountant, but which usually do not require qualification of his opinion. They are (a) disclosures of material information not included in the financial statements, (b) explanation of scope required by Statement on Auditing Procedure No. 12, and (c) explanation of inconsistent application of accounting principles when the change is approved by the auditor.

Disclosure of Material Information.—The standards of reporting (see Chapter 2) require that there be adequate disclosure of

material matters in the financial statements, and if in the opinion of the independent public accountant there is not, he should so state in his report. Preferably, explanatory matter or information should be given in footnotes to the financial statements. As to what constitutes adequate disclosure, the authors deal with these matters in the sections of the succeeding chapters headed "Statement Presentation."

Explanation of Scope Required.—The American Institute of Accountants has approved the report of its Committee on Auditing Procedure (Statement No. 1) that the auditor "shall, wherever practicable and reasonable, be present . . . . at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking . . . . , and that . . . . confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure . . . ." In an amendment to this report in Statement No. 12, the committee recommended that disclosure be required in the short-form report whenever the above procedures are not carried out, regardless of whether they are practicable and reasonable and even though the independent public accountant may have satisfied himself by other methods. In the authors' opinion, in view of the latest revision of the approved form of auditor's report as given in this chapter, the auditor's opinion does not require qualification when he has so satisfied himself and has been able to form an opinion based upon other acceptable audit procedures. Neither do the authors believe that exception should be taken in the closing statement of the scope paragraph, that "Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." An example of disclosure in which the explanation is inserted after the second sentence of the first paragraph of the short-form report is as follows:

> . . . . Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. Complete physical inventory at October 31, 1945 was not practicable, as such inventory would have necessitated an unwarranted interruption of conversion to peacetime production. We were able to substantiate the reliability of the perpetual records of finished product and service parts by means of test counts of quantities on hand. Inasmuch as the restrictions on manufac-

ture of regular products have but recently been removed, there was no great volume of shipments of regular products prior to October 31, 1945, and we were able to substantiate the raw material and work in process inventories recently accumulated by review and tests of the costs incurred.

Explanation of Approved Change in Accounting Principle.—When a company changes from one accounting principle to another, or changes the method of application of an accounting principle, the independent public accountant may be in complete agreement as to the desirability and propriety of the change. Usually the change will affect the comparability of the statements under examination with those of the previous year, and the dollar effect upon comparability will be described in a footnote to the financial statements. The auditor then need only add to the closing sentence of his short-form report language such as the following:

> . . . . in conformity with generally accepted accounting principles, applied on a basis consistent (except for the change indicated in Note —, which change we approve) with that of the preceding year.

Unnecessary Explanations and Qualifications.—The public accountant should avoid unnecessary information or qualifications in his report. For example, disclaimers of responsibility for the correctness of matters which are clearly beyond the scope of an auditor's examination, such as that he has not substantiated titles to real property of the company, are unnecessary and unwise. The reader may infer that these procedures normally should be followed or that the auditor has some doubt of the validity of titles.

Nevertheless, information or explanations contained in the financial statements or in the footnotes may be of such major importance to a proper understanding of these statements, or to an understanding of the independent public accountant's opinion of them, that they are sometimes repeated, or attention is directed to them for emphasis in the short-form report.

CHAPTER 7

FINANCIAL STATEMENTS

Financial statements examined by the independent public accountant and as to which he states his opinion, usually comprise a balance sheet at a stated date and statements of income and surplus for a period, usually twelve months, ended on that date. The auditor reports whether, in his opinion, the financial statements fairly reflect the client's financial position at the balance sheet date and the results of operations for the period covered by the statements of income and surplus, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. The wording of the auditor's report may be taken to imply that the balance sheet displays the financial position, and the statements of income and surplus show the results of operations, but there is difference of opinion among accountants whether the statements of income and surplus are essential to a proper understanding of financial position. This is discussed later in this chapter.

Accounting Principles and Financial Statements.—Neither the balance sheet at a given date nor a statement of income for a specified period can be presented, as some may believe, as the immutable result

of mathematical formulae. While financial statements are based upon business transactions which are facts, and mathematics is employed as one of the tools of accounting, the reflection of the basic facts in the financial statements must, of necessity, involve the exercise of judgment in the application of accounting principles or conventions. The meaning of accounting principles has been discussed, and the principles applicable to specific balance sheet and income statement items are referred to in the succeeding chapters. There are a number of rules of general application which may be mentioned here, although it should be stressed that accounting principles, conventions, doctrines, and rules are not inflexible, but must be adapted to the needs of the business or other entity to which they are applied.

Financial statements are presumed, unless otherwise stated, to be those of a going concern. The balance sheet does not usually purport to present current appraised values of all assets. The conventional basis for stating fixed assets is at cost less allowance for depreciation, even though such amount may be substantially above or below either reproduction cost or realizable value. Certain debit balances subject to final disposition and applicable to future operations, such as prepaid items and deferred charges, are by convention classified as assets on the balance sheet, even though the amounts at which they are stated are seldom realizable or available for payment of debts. Profits are accurately and definitely determinable, except for the effect of changing price levels, only for the entire life of the business enterprise; the apportionment of profit by accounting periods is necessarily tentative at the close of each of the intervening periods.

Conservatism in Financial Statements.—Conservatism in accounting reflects the thought that in applying judgment to an accounting question if there is a choice between two courses, that should be chosen which understates, rather than overstates, the net assets and results of operations. Conservatism, as thus defined, is to be understood as the balancing factor only between permissible alternatives. It does not sanction dishonest understatements.

Formerly, when the greater emphasis was placed upon the balance sheet, conservatism in accounting sometimes led to advocating that expenditures be charged against income when made, even though some part of the expenditure could reasonably be expected to benefit future periods. The conservative point of view was the alleged basis for such practices as charging additions or improvements to plant and equipment to expense accounts; charging off discount on funded debt at the time of sale of the securities; unduly writing down inven-

tories in otherwise profitable years; setting up overgenerous provisions for liabilities, direct or contingent. With the more general appreciation of the importance of the statement of income, there has been recognition that so-called conservatism from the balance sheet point of view might result in relieving subsequent statements of income of part of the charges properly applicable thereto, and thus overstating the income of future periods.

In the authors' opinion, experienced judgment plays a leading role in the application of the doctrine of conservatism to accounting problems. If it is obvious to an experienced accountant that a certain item is a proper charge to fixed assets, good accounting practice does not sanction its charge to income. If experienced judgment indicates that a reasonable doubt exists as to its disposition, good accounting practice permits a charge to income rather than to fixed assets.

Responsibility for Financial Statements.—It should be clearly understood that owners or management are responsible for the financial statements; the auditor is responsible for his report and opinion. The auditor may assist, advise, and persuade management with respect to form and content of financial statements, but he cannot compel management to accept his recommendations. The auditor can, and should, state in his report wherein he disagrees with the fairness of presentation of financial statements if he cannot persuade management to make changes he believes necessary. The auditor's duty to state exceptions in his report is often a compelling argument to induce changes to accord with his views.

A few large corporations authorize their chief financial officer to sign their published statements, which are sometimes accompanied by a short report of this officer. This is sound practice and is recommended by the New York Stock Exchange. It emphasizes the responsibility of management for published financial statements and, by contrast, the responsibility of the independent public accountant for his opinion. It stresses that the auditor's function is to check on management's discharge of its responsibility.

If financial statements reflect adjustments (usually as between periods or as to valuations) which have not been entered on the books, it is good practice for the auditor to secure the client's written approval of the financial statements so prepared. This approval often is obtained on a copy of the financial statements for the auditor's files.

However, an accountant might be engaged by a prospective purchaser of a business, by a creditor, or by the management or owners themselves to prepare from the books and accounts and all other

available information financial statements which he believes fairly reflect the position and results. Such statements might not agree with the books and records in existence and might even reflect views not concurred in by the management. The auditor would then assume responsibility for such changes in the accounts and records as are reflected in the statements prepared by him.

All-Purpose Financial Statements.—The auditor has no practicable method of restricting the ultimate use of financial statements on which he has submitted an opinion. He should therefore urge that the statements in form and content be such as will reasonably meet the needs of most readers. Statements which are designed with this in mind are sometimes termed all-purpose financial statements, as contrasted with statements which may have been prepared to meet special interests of particular readers.

Criticism of the all-purpose financial statement seems to come from two directions. Some feel that such statements should be abandoned in favor of statements prepared for each particular purpose, and argue that because all-purpose statements may be used for obtaining credit, current assets and liabilities are given undue weight, and the effectiveness of the all-purpose statement is therefore limited. Others claim that the special needs of certain classes of readers of financial statements require different or additional information than is customarily provided by statements prepared for general distribution. It is not always clear whether the latter would abandon the all-purpose statements entirely in favor of statements prepared for each particular purpose, or whether they merely desire expansion of material conventionally included in all-purpose statements.

It is true that all-purpose financial statements do not disclose all the special information which is useful for certain purposes. Short-term credit grantors usually provide special forms, and prospective investors are furnished prospectuses, providing to these readers information of interest, most of which could not be shown in any form of financial statement. Management customarily prepares many detailed schedules which it considers necessary for the control of operations as a supplement to conventional financial statements.

There has been and will be progress in the development of more useful financial statements. The authors are the last to take the position that this process should cease. But they believe that the usefulness of the all-purpose financial statements which are usually included in the annual report to stockholders is too well established to warrant their abandonment, and the substitution of a series of special-purpose financial statements.

Financial Statements for Special Purposes.—It is not intended to imply that special-purpose financial statements should never be presented. For many years accountants have been producing, and independent public accountants have been reporting upon, special-purpose financial statements whenever the occasion required. When the auditor is confronted with a special need, he should exercise his imagination, ingenuity, and capabilities to suggest a statement which in form and substance most adequately gives the reader the information he should have.

Balance Sheets with Fixed Assets Stated for Special Purposes.—Balance sheets may be prepared in which the amounts at which fixed assets are stated have been adjusted to indicate valuations significant to special situations. For franchise tax purposes fixed assets may be stated at appraised valuations; for companies in bankruptcy, at estimated liquidating values. The purpose of the statements and the basis of valuation should be clearly indicated.

Condensed Statements.—The auditor is sometimes asked to report his opinion on condensed financial statements. The propriety of doing so depends upon the degree of condensation. If the statements lack information essential to a proper understanding of the company's position or results of operation, the auditor cannot give an opinion without supplying the missing data in his report. It is not unusual, however, that the statements first prepared for his examination and included in a report for internal use contain data which can be eliminated from published reports without violation of the above rule.

Pro Forma Financial Statements.—Pro forma financial statements are those which purport to give effect to transactions actually consummated or expected to be consummated at a date subsequent to that of the date of the statements. Auditors consider it proper to submit their report and opinion on such statements only when the nature of the transactions effected is clearly described in the statements, and when satisfactory evidence of their bona fides is available, such as actual subsequent consummations or signed firm contracts. The rules of the American Institute of Accountants and of the Securities and Exchange Commission regarding certain types of pro forma statements are discussed in Chapter 22.

Other Special Types of Statements.—The special requirements under the Securities Act of 1933 for financial statements to be included in a prospectus for the sale of securities are dealt with in

Chapter 22. The special requirements of short-term credit grantors, and the fact that statements for management purposes are usually in some detail, have been noted. Statements prepared for inclusion in federal income tax returns are frequently adjusted to reflect the status of the accounts under federal income tax regulations.

The peculiar characteristics of municipalities, endowed institutions such as universities and hospitals, estates, and other fiduciaries require that they prepare statements of financial position in forms somewhat different from those suitable for commercial and industrial undertakings.

Railroads, electric and telephone companies, other public utilities, and holding companies which are under the supervision of federal commissions, or state regulatory bodies, use prescribed uniform classifications of accounts.

Bond indentures sometimes contain a provision that financial statements required to be filed with the trustee are to be prepared in some prescribed form which may not conform to customary accounting practice regarding grouping or classification of items. Financial statements prepared under such conditions should be designated to indicate that they have been prepared in a prescribed manner solely to meet specific requirements of the bond indenture. In some cases it may be desirable to indicate wherein such statements differ from those which may have been prepared in accordance with generally accepted accounting principles.

Comparative Financial Statements.—All-purpose financial statements in annual reports to stockholders are frequently presented in comparative form. This presentation is highly desirable, for the information obtainable from the study of balance sheets at the beginning and end of a period, or from a comparison of statements of income for two or more years, is more illuminating than the mere position at a date and the results of operation for one year. Comparative statements indicate whether the concern is showing progress and, to some extent, why.

If the independent public accountant who is to report upon the comparative financial statements has made examinations for the entire period and at each of the balance sheet dates, he has no problem except to see that the necessary explanations, information, and qualifications, if any, are given for all periods reported. If the prior year's statements have previously been certified by the auditor, his current certificate may cover only the current statements or it may be so worded as to cover both the statements presented. If the audi-

tor has examined only one year, and the client wishes to include previous year's unaudited figures for comparison, the auditor's report should clearly indicate that it covers but one balance sheet and one year's operations, and the statements reproduced for comparison should be properly labeled. He should make a reasonable review to ascertain whether the figures for the preceding year seem to be properly comparable with those of the current year, and should insist that any exceptions to comparability are clearly indicated.

Innovations in Financial Statements.—Corporation managements and their independent public accountants have a mutual interest in presenting understandable accounts of stewardship. The search for improved methods of form and content of financial statements has been accelerated in recent years, and accounting literature is full of discussion of the pioneering of certain corporations. Studies by public relations counsel have indicated that many stockholders do not understand common accounting terms.

There are countless possible variations of terminology and of form. Some of them are mentioned below.

Terminology.—The accounting term Balance Sheet is replaced with Statement of Financial Position, or simply, Investment. Instead of the conventional Statement of Income and Surplus, there has been used Statement of Earnings, Summary of Profit Employed in the Business, Results of Operations. The term Surplus is avoided, and replaced with Accumulated Profits, or Profits Retained in the Business. Reserve for Depreciation becomes Cost of Fixed Assets Charged to Prior Operations. There have been some financial statements issued in which all conventional titles for balance sheet and income statement items have been replaced with long descriptive titles which are intended to be more understandable to the majority of readers.

Form.—Most of the innovations as to form of balance sheet are aimed to avoid the impression that it is merely a bookkeeping statement whose principle virtue is that the total of one side equals the total of the other side. The order of the items on the balance sheet has been changed to emphasize that a corporation has an investment in various types of assets, and debts which must be met from them, and that these net assets have come into being through investment by the stockholders plus earnings which they have permitted to remain in the business. Usually this type of balance sheet is accompanied by a single-step income statement, which is described hereafter.

One innovation which the authors heartily favor is that of rounding out all figures on financial statements to the nearest dollar, or even the nearest hundred or thousand dollars. The showing of pennies imparts an unreal impression of exactitude, whereas the truth is that many important items on balance sheets are estimates. Furthermore, statements so prepared are easier to read than are statements showing cents.

There is no objection to experimenting with financial statements in an effort to make them understandable to more stockholders. In the opinion of the authors, most stockholders want to be told three things: the earnings per share of capital stock in the current year, the earnings per share in the preceding year, and the earnings per share that may be expected in the following year. Conventional financial statements will give the stockholders information on current and past earnings per share just as well as any of the newer forms; no form of financial statement predicts future earnings per share. Most reports to stockholders include a letter from the president giving the reader supplemental information. Some companies hold regional meetings of stockholders during the year at different locations to afford them the opportunity to raise questions with the management. Supplementing and amplifying financial statements by these procedures is more effective in getting information to stockholders than are some of the innovations in many statements that have been seen recently.

The Balance Sheet.

Definition.—Strictly, the term "balance sheet" is a technical accounting expression which, according to the American Institute of Accountant's Committee on Terminology, means:

> A tabular statement or summary of balances (debit and credit) carried forward after an actual or constructive closing of books of account kept by double-entry methods, according to the rules or principles of accounting. The items reflected on the two sides of the balance sheet are commonly called assets and liabilities, respectively.

Importance of Balance Sheet.—The trend in recent years toward emphasis on the importance of the income statement to an understanding by investors and others of the financial affairs of a corporation has continued. It is said that the value of a business, and consequently of its assets, depends almost entirely on its earning power. Because of this feeling, there has been some tendency to belittle the balance sheet as a source of information, and to view accounting problems largely from the point of view of the income

statement. It is not to be denied that the earnings of an enterprise as reflected in the income statement are of great interest, and it is highly important that the income statement be prepared on a basis that fairly presents the results of operations for the period. Nevertheless, the balance sheet also has information for the intelligent reader which, in some circumstances at least, is of equal importance to that displayed in the income statement. Such significant relationships as those of total cash to total current liabilities, total cash to total current assets, accounts receivable to sales, inventories to total current assets, fixed assets to funded debt and to the total of capital stock and surplus, total liabilities to capital stock and surplus—all of these and others may convey information of value to the reader of the statements which obviously could not be obtained from the income statement. While the investor properly considers earning power, he prefers earnings plus ample working capital to earnings plus insufficient working capital. For data as to working capital he looks to the balance sheet.

It is worth repeating that, while an important function of the auditor is to determine facts, nevertheless the balance sheet which is the subject of his examination does not reflect facts so much as opinions. When an auditor talks about the facts displayed in a balance sheet, he usually means the descriptive matter, not the figures. For example, it may be a fact that notes receivable are due within one year, but it may not be a fact that they are worth face value. Their value is indicated by giving consideration to the allowance for losses in collection, which is not fact, but opinion. The lower of cost or market is a factual description of a method of stating an inventory, but opinions may differ as to how either cost or market should be determined.

What Is Position?—The independent public accountant states his opinion whether or not the financial statements (balance sheet, statements of income and surplus) fairly present the financial position of an enterprise at a specified date. Question has been raised as to whether the financial position is static or relative; whether the balance sheet alone can give financial position at a specified date, or whether financial position has no meaning unless accompanied by income and surplus statements which help to explain the changes in financial position since the last balance sheet date. The question is raised practically when clients request the public accountant to report upon the balance sheet without statements of income or surplus, and to give an opinion whether such balance sheet fairly presents the

company's financial position. In the past many auditors have given such an opinion and a number continue to do so when requested. Some auditors insist that a statement of financial position at a given date is valueless unless there is some indication of the direction in which financial position has traveled; they insist that at least a summary of surplus be included, which may of course be displayed on the face of the balance sheet. Some auditors believe the statement of income is also necessary to a proper understanding of position.

At one time it was not unusual for short-term credit to be granted on the basis of the balance sheet alone. This practice is no longer prevalent; credit grantors expect their loans to be repaid as a result of profitable operations, and are equally interested in the statement of income.

Form of Balance Sheet.—The problems involved in the determination and proper statement of assets, liabilities, and capital are difficult, and the purposes to be served require that careful attention be given to the description, order, and arrangement of the items. Professional independence of thought may militate against complete uniformity or standardization of balance sheets, but reasonable adherence to commonly accepted standards should be sought. Words which are in common use should be used in their common meaning. Selection of suitable technical words and terms should follow the practice of a majority of accountants.

The authors' concept of an ideal balance sheet is one which sets forth:

1. The assets adequately described, stated at amounts determined in conformity with generally accepted accounting principles, and arranged in appropriate groups in the order of their availability;
2. All known liabilities properly grouped in the order in which they will, or should, be discharged; and
3. The details of capital or, in the case of a corporation, of capital stock to which is added surplus adequately segregated and described, or from which is deducted a deficit from operations.

Most balance sheets are prepared to show all assets on the left side of the page, and liabilities and capital on the right side, with the total of the asset side appearing as an amount equal to the total of liabilities and capital. As a variation of this form, the assets may be shown and totaled on the top half of a page, and the liabilities and capital shown and totaled on the lower half.

The form which is being used by some companies, and which they believe is more understandable to their stockholders, shows net assets as equal to capital and surplus, somewhat as follows:

Current assets	$----------	
Less current liabilities	----------	$----------
Plant and property less depreciation		----------
Prepaid expenses and deferred charges		----------

Less long-term liabilities		----------
Net assets		$----------
Net assets are represented by:		
Capital stock	$----------	
Surplus	----------	$----------

The details of the various assets and liabilities are given, and the terminology used may vary, as mentioned earlier in this chapter.

Another variation in form of balance sheet is that used by most public utility companies whose systems of accounts are prescribed by the various federal and state commissions. On these balance sheets fixed assets and investments appear first on the asset side, and capital stock first on the liability side.

Content of Balance Sheet.—By reference to the definition of a balance sheet, it is evident that it has five main divisions, as follows:

> Name of the individual, business, or organization whose financial position it presents;
>
> Date as at which the statement is presented;
>
> Assets;
>
> Liabilities; and
>
> Capital.

A balance sheet usually has appended explanatory notes and these are discussed later in this chapter.

It is important that the name of the company be given correctly in the balance sheet heading. If a company has been incorporated as "The Mammoth Manufacturing Company, Inc.," its name should appear in the balance sheet exactly so. Omitting "The" at the beginning, abbreviating the word "Company," or changing "Inc." to "Incorporated" are undesirable alterations. If the state of incorporation is not part of the name of the company, it is considered desirable by some to parenthesize the information directly beneath the company's name, but this practice is not widely followed.

Captions which are intended to identify the various groups of items should be self-explanatory. The words "Liabilities" and "Capital" are concise, expressive, and accurate group descriptions of the items appearing on the right side of the balance sheet. The heading "Liabilities, Reserves, and Capital" should be avoided because the word "Reserves" has been given a variety of meanings by writers and care should be taken to restrict the word to its proper use.

Assets, liabilities, and capital in the form of balance sheet most frequently used are generally grouped as follows:

ASSETS	LIABILITIES
Current assets	Current liabilities
Long-term investments	Long-term liabilities
Fixed assets	
Noncurrent prepaid expenses and deferred charges	CAPITAL
Intangible assets	Capital stock
Miscellaneous	Surplus

In many balance sheets other captions may be necessary to designate groupings of balance sheet items.

Definitions of the above terms are included in the chapters of this book devoted to the respective subjects. These chapters include comment on the preferred presentation in the balance sheet of the items generally included in the various categories.

Working Capital.—The working capital of a prospective borrower has always been of prime interest to grantors of credit. Working capital, sometimes called net working capital, has been defined as the excess of current assets over current liabilities and represents the relatively liquid portion of the total enterprise capital which constitutes a margin or buffer for meeting obligations to be incurred and liquidated within the ordinary operating cycle of the business. The average time intervening between the expenditure of cash for goods and services which become inventory to be sold and converted into trade receivables, and the time when such receivables are collected in cash, constitutes an operating cycle.

The operating cycle of the majority of businesses is less than one year, and because most financial statements are publicly issued annually, the test usually applied to determine whether an asset should be included in current assets is whether it will normally be converted into cash within one year. When the operating cycle is greater than one year, as in the tobacco, distillery, and lumber

businesses, and in those which customarily sell goods on a long-term installment basis, the longer period should be used, usually with an indication of the basis by footnote to the statements.

The Committee on Accounting Procedure of the American Institute of Accountants in Bulletin No. 30, issued in August, 1947, discusses its opinion as to the determination of working capital, with most of which the authors are in agreement.

The Statement of Income.

Definition.—The statement of income has been defined by the Committee on Terminology of the American Institute of Accountants as follows:

> An account or statement which shows the principal elements, positive and negative, in the derivation of income or loss, the claims against income, and the resulting net income or loss of the accounting unit.

There have been objections to the title on the grounds that it does not sufficiently emphasize that income is the result of positive and negative elements, as does the less usual title Profit and Loss Statement. There is some merit in this objection and the point might well be considered by those who are experimenting with different terminologies for financial statements.

The items entering into the income statement may be broadly classified as follows:

1. *Sales and Other Revenue from Operating Sources.* This includes gross sales, which means all sales of goods, either delivered or to which title has passed to the vendees, less returned goods or goods to be returned, trade, quantity and similar discounts, and all allowances which, if known at time of invoicing, would have been deducted from the sales prices, such as allowances for price changes, damaged goods and shortages; and charges for services rendered by public utilities or similar enterprises.
2. *Income from Other Sources,* such as dividends and interest.
3. *Profits* arising from sale of fixed assets, and extraordinary income.

with the following deductions:

1. *Charges Against Sales and Other Revenue from Operating Sources,* such as cost of goods sold or of services rendered; inventory write-downs; cash discounts (often deducted directly from sales); allowances not properly deductible from

sales; selling, general and administrative expenses; depreciation and depletion (when not included in cost of goods sold); and any other charges and expenditures properly chargeable to current operations.

2. *Other Deductions from Income,* such as interest on borrowed money and federal and state income taxes.
3. *Losses* arising from sale of fixed assets, and extraordinary charges.

Purposes of Statement of Income.—Owners and managers require frequent reports of accomplishment, and it is an important function of accounting to furnish data for periodic reports of results of operations. Such reports indicate the financial results of past policies, and may point the way to new managerial decisions.

Accounting can only record that which has happened, and reflect opinion on the basis of knowledge at the time statements are prepared. Statements of income, therefore, are historical, not prophetical; they purport only to be an historical record of income, expenses, profits or losses during the period or periods to which they relate.

The statement of income, when read with the accompanying balance sheet, indicates the relation of earnings to capital employed. Statements of income reflect the operating history of a business, which is useful in estimating its future possibilities. They are important, therefore, to present or prospective stockholders who may contemplate changes in their investments.

All-Inclusive vs. Current Operating Statements of Income.—A full discussion of two different views of the proper preparation of the statement of income is given in Bulletin No. 32, issued in December, 1947, by the Committee on Accounting Procedure.

The all-inclusive income statement reflects net income according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period, except dividend distributions and capital transactions.

The current operating performance income statement's chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the year covered by the statement, and places its principal emphasis upon the relationship of items to the operations, and to the year, excluding from the deter-

mination of net income any material extraordinary items which are not so related.

The Committee stated its opinion that

> . . . . there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, only extraordinary items such as the following may be excluded from the determination of net income for the year, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom:
>
> (a) Material charges or credits (other than ordinary adjustments of a recurring nature) specifically related to operations of prior years, such as the elimination of unused reserves provided in prior years and adjustments of income taxes for prior years;
>
> (b) Material charges or credits resulting from unusual sales of assets not acquired for resale and not of the type in which the company generally deals;
>
> (c) Material losses of a type not usually insured against, such as those resulting from wars, riots, earthquakes and similar calamities or catastrophes except where such losses are a recurrent hazard of the business;
>
> (d) The write-off of a material amount of intangibles, such as the complete elimination of goodwill or a trademark;
>
> (e) The write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of retirement or refunding of the debt before maturity.

The Committee's opinion is in accord with the position taken in previous editions of this book. The Committee appears to intend that the surplus account be used very sparingly, and the burden of proof is on those who wish to make charges or credits thereto rather than to income. On this basis there should be relatively few instances where the statement of income prepared on the all-inclusive basis would differ from that prepared on the current operating basis.

The Committee's opinion as to the manner in which current income taxes should be prorated to surplus charges and credits is stated in Bulletin 23, issued in December, 1944.

Form of the Statement of Income.—Like the balance sheet, the statement of income may be prepared in a variety of forms and with considerable variation in terminology. Reasonable uniformity is desirable to facilitate comparison with other periods and other businesses, but form must be subordinated to clarity. A form of statement commonly used is as follows:

Statement of Income for the Year Ended December 31, 19—

Gross sales less returns, allowances, freight and cartage
Cost of sales
        Gross profit
Profit (or loss) on other operations
Advertising and selling expenses
Administrative and general expenses
        Operating profit
Other income
    Interest and dividends
    Miscellaneous
Other deductions
    Interest paid
    Miscellaneous
        Income before federal taxes on income
Provision for federal taxes on income
        Net income for the year

A form of income statement which has gained some prominence recently is called the single-step income statement, because it arranges all items of income first, totals them, lists all items of costs, losses and expenses, including federal income taxes, and deducts the total of the latter from total income to arrive at net income without intervening balances. An illustration of this form follows:

Statement of Income for the Year Ended December 31, 19—

Sales and other income:
    Gross sales, less returns, allowances, and freight
    Dividends and interest income
    Other income

Costs and expenses:
    Cost of goods sold including depreciation
    Advertising and selling expenses
    General and administrative expenses
    Interest on long-term debt
    Provision for federal income tax
        Net income for the year

Sometimes the deductions are arranged to show the total employment costs (wages and salaries, social security taxes and pensions) and total taxes (state, local, and miscellaneous, with federal income taxes shown separately). The proponents of this last form believe that it eliminates poorly described subtotals of doubtful significance. There can be no profit, in any proper sense, until all income and all costs have been taken into account. The single-step statement indicates that no cost or expense has any priority over any other. This is urged with special force as to federal income taxes, and one eminent teacher and author says we should ". . . . make it plain that they (federal income taxes) are deductions from revenue, along with other taxes and expenses in the process of measuring corporate net income."[1]

Objections to the single-step statement are that the intermediate balances shown in the more conventional type of income statement, such as gross profit on sales, operating profit, and income before and after provision for federal income taxes, are significant to most readers and if not supplied they will have to make their own calculations of them. It is also stated that a great part of the significance that ought to be attached to such items as the provisions for income tax, certain reserves, and extraordinary losses is obscured when such amounts are grouped with ordinary costs and expenses. A former chief accountant of the Securities and Exchange Commission expressed the opinion that the omission of significant intermediate balances in income statements filed with the Commission might be the basis for the citation of a deficiency.[2]

Disclosure of Amount of Sales.—The present trend of published financial statements is in the direction of fuller information. It is now less usual to find statements published which omit net sales and cost of sales from the statement of income. Both the Securities and Exchange Commission and the New York Stock Exchange have helped to bring this about through their rulings and requests.

Disclosure of Extraordinary Items.—In analyzing a statement of income as a basis for drawing conclusions as to future possibilities, the reader will wish to consider the probability of recurrence of the various items of income and expenses. For example, an increase in the amount of current operating income would have a different significance than a gain on sale of capital assets. It is important, therefore, that in preparing statements of income for in-

[1] W. A. Paton, 56th Annual Meeting of American Institute of Accountants.
[2] W. M. Werntz, "Contemporary Accounting."

clusion in annual reports to stockholders extraordinary items of income or expenses, or items recognized in the accounts of the current period which apply to a previous period, should be disclosed in such a manner that they may readily be recognized. The authors believe that frequently there may be charges or credits of extraordinary or unusual nature which should be shown in the income statement in such a manner that their significance is not lost on the reader, but which are not so material in relation to the company's net income that they properly should be excluded from the determination of net income for the year. Such items should be similarly treated under either the all-inclusive or the current operating basis of income statement preparation. Depending on the circumstances, their display might be under the "Other income" or "Other deductions" heading, or if representing adjustments of prior year income taxes, separately under that caption. Alternatively, the statements may be prepared to show income before and after such extraordinary items, somewhat as follows:

Net sales
Cost of sales
    Gross profit on sales
Selling, general, and administrative expenses
    Profit before other income and deductions

Other income
Other deductions
    Income before extraordinary item below and provision for federal income tax
Extraordinary item (describe)
    Income before provision for federal income tax
Provision for federal income tax
    Net income for the year

If the extraordinary items are such that under Bulletin 32 they may be excluded from determination of income for the year, the Committee on Accounting Procedure in Bulletin 35, issued in October, 1948, states that ". . . . it recommends that the net income for the period be shown henceforth without deductions or additions of items which are properly excluded from the determination of net income." Such charges or credits preferably should be shown in the surplus statement less the related addition to or deduction from federal income tax for the year.

As previously stated, the Committee, in Bulletin No. 32, is of the opinion that items from the determination of current year's net in-

come may be excluded only in clear-cut cases where to do otherwise would seriously impair the significance of net income so that misleading inferences might be drawn therefrom.

It may be desirable to show current items of income or expenses of an unusual nature separately in the statement of income. A strike in a company's plant may cause extraordinary expenses for transporting nonstriking workers, guards, and similar expenses. While there is no question that the expenses are applicable to the year in which they occur, and nowadays strikes are practically a normal hazard of business, it may be desirable to state these expenses as separate operating charges if they are susceptible of reasonably accurate determination.

It is sometimes urged that inventory losses or gains be separately shown in the income statement. This is more frequently urged when falling market prices necessitate a write-down of inventory on hand at the year end. Concerns which are willing to disclose an item of extraordinary inventory write-down are not always willing to disclose an extraordinary profit in a succeeding year which may result from this write-down. It is usually very difficult, as a practical matter, to distinguish all the factors contributing to normal operating profit or loss and to segregate those which may be considered extraordinary. In the authors' opinion, while unusual operating factors may properly be referred to in explanatory comments accompanying a statement of income, the auditor should be cautious in expressing them separately in figures in the income statement. If unusual operating income or expense items are stated below operating income, it should be made clear in the statement that the item of operating income is before such charges or credits.

The preparation of the statement of income when it contains extraordinary or unusual items of varying degrees of materiality requires experienced and informed judgment to make reasonably clear to the reader the proper appraisal of the importance of these items in interpreting the results of operations.

Disclosure of Depreciation.—The importance of the disclosure of the amount provided for depreciation has been stressed by the stock exchange, bankers, and others interested in more fully presenting the component parts of net income. Depreciation may be disclosed either by the inclusion of this charge among the costs and expenses with parenthetical indication of the amount, or by showing it under a separate caption. For example:

Cost of sales (including depreciation of $---------) ...... $--------- or,
Cost of sales before depreciation (with depreciation stated as a separate item in a caption below) .... $---------

In concerns such as public utilities, trading, or commercial companies, one of the above methods may be employed as the allowance for depreciation is easily identified in the expense accounts. In manufacturing concerns there are difficulties in determining the amount of depreciation to be separately stated. In a manufacturing business it is usually found that depreciation has been included in the overhead which is prorated over a number of departments and products, and finds its way ultimately into cost of sales through inventory accounts.

To determine the amount of depreciation which is included as a part of the cost of merchandise sold may require an extensive analysis of cost accounts, usually impractical, if not impossible. The auditor usually solves the problem by suggesting that the amount of depreciation charged to manufacturing costs and to expense accounts during the year be taken as representing the amount which was charged to income. Obviously this method does not correctly state the actual amount of depreciation charge which was recouped through sale of the goods into which depreciation entered as an element of cost. From a practical standpoint, in view of the indicated difficulty, if not impossibility, of determining the exact amount of depreciation included in cost of sales of a manufacturing company, it has become recognized practice to report the amount of depreciation charged in the statement of income for the year as that which has been charged to manufacturing costs and to expense accounts, even when inventories at the beginning and end of the period are of such amounts that there would result a recognizable effect on the depreciation included in cost of sales. Such practice also is acceptable when applied to statements filed with the Securities and Exchange Commission.

Statements of Surplus.—Most accountants believe, and the short-form report of the independent public accountant implies, that the results of operations of the business for a period of time are disclosed by the statement of income together with the statements of surplus, whether earned, paid-in, or other specially designated surplus. This is true because the operations of a business comprise extraordinary charges or credits, changes in capital structure, restatements of assets, dividend distributions, and other transactions which are reflected in one or more of the surplus accounts.

A form of combined statement of income and earned surplus is sometimes used, and it has been approved by the Committee on

Accounting Procedure in Bulletin No. 8, and reaffirmed in Bulletins Nos. 32 and 35. It has the advantage of bringing the figure of net income for the year in close juxtaposition to items which may have been shown in the earned surplus statement as permitted in Bulletin No. 32. An example of this form (beginning with "Income before taxes on income") is:

Income before taxes on income		$10,000
Provision for taxes on income:		
Federal income tax	$ 3,500	
State income tax	500	4,000
Net income for the year		6,000
Add earned surplus at beginning of year		50,000
		56,000
Deduct:		
Dividends on capital stock	$ 3,000	
Excess of fire loss over proceeds of insurance carried	20,000	23,000
Earned surplus at close of year		$33,000

A statement of any surplus other than earned surplus likewise includes the balance at the beginning of the period, a description of the additions and deductions, and the balance at the close of the period.

Statement of Net Income for Bonus or Profit-Sharing Purposes.—For years many business concerns have paid bonuses to, or shared profits with, officers and other employees, especially in profitable years. A large number of companies have entered into contracts with officers and other employees which provide for sharing in the annual net income of the companies. Others, including a substantial number of large corporations, have bonus plans under which a part of net income of each year is set aside to provide incentive compensation or bonus awards to officers and other employees; such bonus plans may contain provisions such as that officers and other employees have no equity in or right to the net income so set aside and that awards need not be made in the full amount set aside each year.

Such a bonus or profit-sharing plan or contract should define the net income upon which the amount to be set aside or to be paid is to be calculated. The starting amount in the determination of such defined net income may be stated in the bonus plan or contract as the net income which is shown in the annual statement of income; in other cases the kinds of income and deductions to be included in arriving at such net income may be listed. It is usually undesirable to rely on listing items of income and deductions to be included in

computing net income to be used as a starting point because it is impossible to foresee and include all material kinds of extraordinary or infrequent income or expense.

In the absence of provision in the plan or contract whether income taxes are to be deducted in arriving at net income, these taxes, computed on net taxable income after deduction of deductible amounts set aside under the bonus plan or for profit sharing, are a necessary deduction in the case of a corporation. In the cases of single proprietorships or partnerships the inclusion or exclusion of income taxes, partners' salaries, and interest on partners' capital should be specified.

The intent of bonus and profit-sharing plans and contracts is to divide net income between stockholders or owners and officers and other employees. If the amount set aside for officers and other employees is deducted in arriving at net income upon which the percentage for such officers and other employees is computed, the result is that they will be allocated less than the stated percentage of net income. The deductibility of the amount set aside under a bonus or profit-sharing plan or contract in arriving at defined net income should be stated in the plan or contract; in the absence of a specific provision a number of court decisions have expressed the opinion that it would be unreasonable to deduct the amount so set aside in arriving at net income to be used in computing the amount under the bonus or profit-sharing plan or contract. The authors agree with the opinion of the courts.

Many bonus plans and profit-sharing agreements have defined corporate net income as the amount of net income, determined in accordance with generally accepted accounting principles, shown on the annual statement of income as certified by the company's independent public accountants. This net income may not be a fair amount for the purpose if, under the current operating theory of income statement preparation, certain items are included in surplus rather than in income. For example, it would be unfair to exclude from net income the return of the unused portion of a provision for a liability of uncertain amount charged against a prior year's net income upon which a bonus plan or profit-sharing amount was computed merely because, in the year of restoration, the amount materially distorts net income and therefore is credited directly to surplus. On the other hand, it might be unfair, in the case of bonus plans or profit-sharing agreements recently instituted to charge or credit income for use under such a plan or agreement with material amounts relating to years prior to the beginning of the plan or agreement,

as for example material additional federal income taxes or refunds thereof applicable to such prior years but credited to current income under the all-inclusive theory that such items should be included in net income for the year.

A bonus or profit-sharing plan or agreement may seem clear at the time written, but questions of interpretation may arise if extraordinary items are charged or credited directly to surplus, as recommended in Committee on Accounting Procedure Bulletin No. 35.

A number of corporations have written and rewritten definitions of net income for purposes of bonus or profit-sharing plans or contracts which attempt to avoid misunderstandings and inequities. General Motors Corporation, which has had a Bonus Plan since 1918, stated the following in the notice of annual meeting of stockholders for 1947 (prior to the issuance of Bulletin No. 35 referred to above):

> It has been the practice of the Corporation over a long period of years to include in the income statement in arriving at "net income for the year" all revenues, income, costs, expenses, losses and provisions for reserves and restorations of reserves, whether or not the items are extraordinary or nonrecurring or might be attributable to operations of other years. It is recognized, however, that the accounting practices of corporations with respect to financial statement presentation are not uniform, and that it is possible that there might be a change in accounting technique which would result in an income statement which would exclude from the determination of "net income for the year" extraordinary or nonrecurring items and include such items in a section of the income statement immediately following the amount of "net income for the year" but prior to the determination of the amount to be carried to earned surplus from the income statement. It is not considered that any such change in the technical presentation of the income statement should affect the determination of "net earnings" for bonus purposes. It is therefore proposed to modify the definition of "net earnings" so as to assure continuance of the traditional intent of the Bonus Plan that there shall be included in the bonus calculation of any year the total amount reported in the income statement and carried to earned surplus in that year, whether or not such "net earnings" were affected by extraordinary or nonrecurring items or items attributable to other years. Provisions for reserves or reserves that are restored to income in any given year have been consistently included in "net earnings" as now defined and will continue to be included under the proposed definition.

Uniform Terminology in the Statement of Income.—The multiple-step form of income statement leads to the description of

the result of each addition or substraction. This has contributed to lack of uniformity in published reports of many corporations. The terms "gross income," "gross profits," "net profits," "net operating income," "profits," "revenues," and "earnings" have been used according to the taste of each writer, and generally acceptable definitions of these terms have not been attained. This lack of uniformity of terminology tends to obscure comparison of operating results of one company with those of another. One solution of the difficulty is to omit any description of intermediate balances and describe only the final figure of net income for the year.

Accountants should agree on terms which describe similar items. The public apparently finds it difficult enough to understand financial statements, and it does not help to find terms employed to which different meanings can be ascribed. Unfortunately it is very difficult to obtain agreement on terminology. The American Institute's committee on this subject has been laboring for many years without conspicuous success.

The terms "net earnings" and "net profits" are used to describe various balances of the multiple-step income statement, but not necessarily always the same steps. There is more general agreement that the final figure should be called net income, and that the net income of a business is the remainder of the earnings and profits from all sources after providing for all costs, expenses, and reasonably determinable losses.

Explanatory Notes to Financial Statements.—It is one of the standards of reporting (Chapter 2) that there be adequate disclosure of material matters in financial statements, and if in the opinion of the independent public accountant there is not, he should so state in his report. It is extremely rare that the auditor must insist on disclosure in his report. If it is merely a choice of location, the auditor should recommend that disclosure be made in the financial statements rather than in his report.

There are several types of information which by custom or convenience are given in notes to financial statements. When this is done, a note is often placed on the financial statements themselves referring to the accompanying notes and stating that they are an integral part of the financial statements. The authors believe that even without such reference, the accompanying notes are in fact part of the statements, but the precaution is well taken. So far as is known, there has been no legal decision in which the point was at issue.

The principal types of notes of explanation are these:

1. Notes made to provide additional factual details beyond those which may be feasibly incorporated in the statement proper as, for example, a note describing a company's depreciation policy.
2. Notes made to provide interpretative comment as an aid in appraising the significance of items in the statement proper as, for example, a note stating the basis used in determining cost of inventories, i.e., first-in, first-out, average.
3. Notes made to provide facts which by convention are not included in the statement proper as, for example, a note giving amount of cumulative unpaid dividends.
4. Notes made to explain the degree of uncertainty attaching to an asset or liability of material amount, as, for example, the status of a tax controversy with the United States Treasury Department.

Some financial statements have been issued in which the descriptive matter was eliminated to the greatest possible extent, and was shown in accompanying notes instead of on the face of the statements. The purpose was to simplify the statements to the casual reader. Whether the purpose was furthered by this practice may be debatable.

The question of what constitutes adequate disclosure of material items in financial statements is dealt with under the heading "Statement Presentation" in the succeeding chapters. The question whether the auditor should refer in his report to information contained in the fourth category of notes listed above has been discussed in the previous chapter.

Disclosure in Financial Statements of Events Subsequent to the Balance Sheet Date.—The auditor is necessarily present at the client's office for a certain period of time after the date of the balance sheet under examination, because his field work requires some time for its completion. The auditor always has considered certain post-balance sheet transactions for the light they shed upon the accounts at the balance sheet date. For example, the best proof of the worth of an account receivable at the balance sheet date is its subsequent collection; if a liability, uncertain at the balance sheet date, is settled by negotiation before completion of the auditor's examination, the basis of the settlement should be reflected in the balance sheet.

There may come to the auditor's attention transactions which would not properly be reflected in the financial statements under examination, because they relate entirely to the subsequent period, but which nevertheless are of interest to a prospective investor or creditor in his consideration of the financial statements. Such events might be changes in capital structure, expansion of plant facilities, or development of new products or new markets. There is a growing tendency to disclose major transactions of this sort in a footnote. There are other borderline events, but in general if they are of a character which would not have required disclosure had they occurred prior to the year end, it is not usual to mention them in the financial statements.

The responsibility for ascertaining and disclosing material transactions or events subsequent to the date of the balance sheet rests with the management, although the auditor may learn of them through inquiry, inspection of minutes, or substantiation of the accounts for the year under review. The auditor must form an opinion as to the necessity for and the adequacy of disclosure of those subsequent events that have come to his knowledge. The special requirements in regard to disclosure of subsequent events under the Securities Act of 1933 are discussed in Chapter 22.

CHAPTER 8

CASH

The volume of transactions in the cash account is greater than in any other and through it eventually flow most of the activities of business. Few items on the balance sheet can be stated as precisely as can cash; only occasionally is there a question of evaluation. Because it is the medium of exchange and because of its mobility it is more susceptible to manipulation than are other assets. The audit of cash can be time consuming, and in determining its extent the auditor will be guided by the purpose of the examination and his review of the system of internal control.

ACCOUNTING PRINCIPLES

Cut-Off of Cash Receipts and Cash Disbursements.—Cash on a balance sheet should include only cash on hand or deposits in banks at the close of business on the balance sheet date. Disbursements of the period ending on the balance sheet date should include only checks prepared and delivered, or on their way, to creditors before the close of business on that date. These considerations are particularly important when there are ratios of current assets to current liabilities to be maintained in accordance with provisions of bond indentures or preferred stock issues.

The books should not be held open after the close of the period to include receipts after that date, even though debtors' remittances are dated thereon or prior thereto. Nor should they be held open to reflect an improvement in the current position by reducing both the indebtedness outstanding and the cash balance.

The practice of including in the cash of a period receipts of the first few days after the close of the period, reducing accounts receivable correspondingly, is defended by those who engage in it on the ground that the payments were forwarded to them by the debtors before the close of the period and therefore represented cash in transit. It is, however, a well-accepted accounting rule that only items which represent cash on hand or deposits in banks at the close of the period should be included in the cash balance. Checks drawn prior to the balance sheet date, but held for later delivery to creditors, and checks drawn after, but dated prior to, the balance sheet date should not be treated as outstanding checks; they should be restored to the cash balance and to liabilities.

If the client insists on holding open the books for window dressing, the auditor should advise him that bankers and credit men are strongly opposed to this practice and that when they find a concern engaging in it they are inclined to assume that other devices have been used to present a better financial statement than the circumstances warrant. If the client persists and the amount is material the auditor must qualify his report accordingly.

Organizations for charitable, religious, and similar purposes usually operate on a budget, disburse income in its entirety, and keep their books open for both cash receipts and disbursements. The close relation of budgeted income and expense leads these organizations to force one to equal the other. They claim that the resulting statements present more fairly results of operations and the financial position to the persons for whom they are prepared. If the auditor discovers in his examination of such an organization that there has been a deviation from acceptable accounting practice in the treatment of cash at the end of the period, his report, at a minimum, should describe the policy followed by his client and disclose the amounts involved. He may well consider whether he should qualify his opinion of the statements.

Cash in Foreign Currencies.—Foreign currency on hand and on deposit in foreign countries should be included in the balance sheet translated at the rate of exchange in effect on the balance sheet date. Translations are usually at official rates, but when transactions have

been settled during the period principally at free rates or when there are other indications that the free rate will be used in the future, that rate should be used.

Unrealized losses on translation are normally charged against income. Accounting Research Bulletin No. 4 issued in December, 1939, indicates that unrealized losses on translation may be charged against surplus if a charge against income "would seriously impair the value of the income statement as an indication of earning capacity." However, Bulletin No. 32 issued in December, 1947, indicates that such charges should preferably be against income and the loss should be clearly disclosed. Unrealized gains on translation should be credited to income to the extent to which such gains represent recovery of unrealized losses previously charged to this account, or, if there have been no previous unrealized losses, to a reserve, taking into income only realized gains.

INTERNAL CONTROL

Adequate procedures of internal control minimize the risk of loss, but it is recognized that they are not always practicable in small offices or under all circumstances. In a small office there are too few employees for effective segregation of accounting functions. It is not always possible to get petty cash receipts that conform to practices of good internal control in all details; for example, receipts from truck drivers are seldom executed in ink with amounts spelled out as well as written in numerals. Reasonable compromises between effective internal control and practicability must often be made.

Cash Receipts.—Receipts of cash can be safeguarded by procedures which include controls of cash sales, incoming mail, and bank deposits. Cash sales should be recorded in the presence of customers, in mechanical cash registers, or on prenumbered receipts or sales slips. Incoming mail should be opened by someone other than the cashier or accounts receivable bookkeeper. A detailed record of receipts should be prepared by the employee who opens the mail. This list, after adjustments for unsatisfactory remittances, together with receipts from cash sales, should be compared in detail daily by an employee independent of the cashier's department, with the cash receipts record. Each day's receipts, both checks and cash, should be deposited intact and without delay. They should at no time be mingled with petty cash funds. Duplicate deposit slips, after authentication by the bank, should be received by an employee not responsible for making up the deposit or depositing the cash in the bank and com-

pared in detail by that employee with the cash receipts record. Overs and unders should be under accounting control.

Deposit or collection items charged back by the bank as uncollectible should be delivered to an employee other than the one making the deposit or the accounts receivable bookkeeper. Post-dated checks and deficient remittances should be under accounting or statistical control. Branch office collections may well be deposited in bank accounts segregated from operating accounts and subject only to withdrawal by the home office. Other negotiable assets should be in the custody of employees other than the cashier. All bank accounts should be authorized by the board of directors.

Cash Disbursements.—Disbursements, other than those from petty cash funds, should be made by check; a check protector should be used; checks should be prenumbered and accompanied by properly approved vouchers when presented for signature; checks unused should be kept under control. Checks should be signed by employees having no access to cash receipts. Payment should be clearly indicated on supporting vouchers or the vouchers should be mutilated to prevent their use in support of a duplicate payment.

The signing or countersigning of checks in advance should be prohibited. The dangers of signing checks in advance are obvious, but often are ignored. Countersignatures are effective as an internal control procedure only when each signature is affixed after examination of checks, completed except for signatures and accompanying vouchers. The affixing of one signature on a blank check requiring two signatures is particularly dangerous, for then the requirement of signature and countersignature implies a security that is not present. The second signer of the check may accept the first signature as indication of approval of the payment and examine the accompanying documents less carefully because of it. Furthermore, the board of directors or other executive body in setting up the requirement of signature and countersignature intends that expenditures will be subjected to reasonably careful examination by two employees and rests comfortably in the assurance that procedures have been established to prevent the misuse of funds. Countersignatures properly affixed are well and good, but signature by one employee after examination of supporting vouchers offers much greater protection than countersignatures misused.

The use of a mechanical check signer should be controlled. Usually the equipment provides for counting and occasionally for listing the checks signed. Control should be exercised over the number of

checks signed and, if feasible, over the amounts as well. The check signer or the signature plate should be available only to employees authorized to use them.

Spoiled checks should be replaced with other prenumbered checks of the same series; they should be mutilated and filed in their place in the numerical sequence with checks cleared through the bank.

Some compromise must be made between strict accounting control and expediency in the handling of unclaimed cash wages. Obviously it is often not practical to return them to general cash the day they are unclaimed. It is reasonably safe practice to hold them for two weeks or a month, at the end of which time they should be returned to general cash and a liability for unclaimed wages credited. They should be held by an employee whose duties are divorced from the pay roll preparation and who handles neither cash receipts nor petty cash. If unclaimed wages are paid by check, it is nevertheless good practice to establish a routine for return of these checks to general cash after a specified period.

When pay roll disbursements are made by check and the number of employees is large an imprest bank account restricted to that purpose is desirable. The practice of drawing checks to cash should be prohibited.

Petty cash disbursements should be made from an imprest fund, the responsibility for which should be vested in only one person. The custodian of petty cash should not have access to cash receipts or accounting records.

All expenditures from petty cash should be supported by properly approved and prenumbered vouchers, executed in ink, with amounts spelled out as well as written in numerals and signed by the recipient of the funds disbursed. These vouchers should be reviewed before petty cash is reimbursed and, together with supporting documents, should be mutilated, preferably by perforation, to prevent their use to support a duplicate payment. Many misappropriations have been perpetrated through petty cash funds; the establishment of, and adherence to, routines governing expenditures from these funds reduce the possibilities of their misuse.

Petty cash funds should be limited in amount to the cash requirements of a short period of time and single expenditures from these funds should be limited by a specified maximum amount. An internal auditor or other independent employee should count petty cash funds at unannounced intervals. Both the fund itself and the expenditures from it may be petty, but over a period of time misappropriations may be large if adequate safeguards are not maintained.

Reconciliation of Bank Accounts.—All bank accounts should be reconciled promptly and at least monthly by an employee whose duties do not involve the recording or handling of cash or the signing of checks. Bank statements and paid checks should be received directly from the bank by the employee reconciling the accounts.

The employee reconciling bank accounts should compare paid checks with disbursements records for date, payee, and amount; bank cancellations, endorsements, and authorized signatures should be examined; and the sequence of check numbers should be established. In times of pressure many large commercial banks have abandoned their practice of examining endorsements of checks returned and paid through the clearing association. If, because of similar pressures, the banks' customers also omit the procedure of scanning paid checks for the payees' endorsements, a significant safeguard over the integrity of cash payments is lacking.

Checks should not be listed indefinitely as outstanding on the bank reconciliations. A reasonably safe practice is to stop payment after a year has elapsed, return the amounts to cash and credit a liability account. The liability account should be debited and income credited after the applicable statute of limitations has run, unless the laws of the state which govern provide for other disposition. Dividend checks may require special treatment, for the laws of some states make a distinction between the liability for uncashed dividend checks and for other uncashed checks.

AUDITING PROCEDURES

Scope of Examination.—The auditor's examination of cash should be sufficient to afford a reasonable basis for his opinion that cash as stated on the balance sheet is actually available without restriction or with restrictions as indicated. Because cash lends itself to precise determination there is an inclination to adopt auditing procedures that leave little likelihood of even insignificant error in the amount as stated in the balance sheet. The detection of embezzlement or kindred frauds was once a primary purpose of an examination by an independent public accountant, but with the increase in the size of business organizations and in the number of transactions this purpose has become less important. The present-day aim of audit procedures for cash should be comparable to that for the examination of receivables, inventories, and other current assets: to state the amount fairly, but not necessarily precisely. Only recently, however, have audit programs for cash examinations begun to recognize this change and the recognition is not yet complete.

Cash examinations are often more detailed than the relative importance of the asset justifies. Pursuing obvious procedures it is comparatively easy to make an extended examination of cash; the difficulty is to devise shorter procedures that will give the auditor a sound basis for his opinion. It is here that the auditor must exercise judgment, giving due consideration to the degree and effectiveness of his client's internal control procedures.

Information to Be Obtained in Advance.—Before beginning an examination of cash the amounts and locations of all cash funds and the locations of all bank accounts and other negotiable assets should be determined. The auditor should also inquire whether any custodian of cash is an officer or financial agent of another organization. The possibilities of misappropriation when one person handles funds of two or more organizations must not be overlooked. A review of the client's procedures in handling cash and other negotiable assets is essential in determining what procedures and controls should be established.

Failure to make an adequate preliminary survey may result in serious inconvenience. Because of the mobility of cash the auditor may find himself in the embarrassing position of having to do his work over, if, for example, he has not ascertained in advance that the cashier is treasurer of an employees' organization or custodian of unclaimed wages, employees' savings, or other cash not appearing on the books. Or he may find that the time allotted to the examination is not sufficient because of his failure to determine the number of locations to be covered or the extensions of auditing procedures made necessary by weaknesses of internal control. A preliminary survey of other items on the balance sheet is usually advisable, but it is particularly important in the examination of cash.

Simultaneous Examination.—Cash funds and undeposited receipts should always be examined simultaneously with other negotiable assets such as marketable securities, notes receivable, and collateral held as security on loans to others. If simultaneous physical examination of all negotiable assets on hand is impossible, the auditor must establish control of all such assets so that a shortage in one cannot be covered up by the use of another previously examined. This is usually accomplished by counting less active negotiable assets such as reserve cash and notes receivable in advance and placing them under seal until completion of the count, at which time the seals must be examined to determine that they are unbroken. It is occasionally necessary to permit movement of assets under seal; if it is, the auditor should control and record all such changes.

Count of Cash on Hand.—The auditor should, if possible, arrange to make his count of cash funds and other negotiable assets at some date and hour unknown in advance to the cashier. Whenever it is feasible to make an unexpected initial count, the auditor should take advantage of this opportunity to detect possible shortages. When cashiers know that the auditor is about to begin work on a regular annual engagement, a surprise count is out of the question. The auditor can then arrange to count the funds at such a time as will cause the cashier the least inconvenience. If it is desirable, a surprise second count may be made before the completion of the engagement. If the auditor is in the client's office at the close of the period it is customary to count funds at that date. With increased pressure of work at the year end auditors are inclined to rely more and more on counts of cash at other than year end dates when review of the system of internal control indicates that the client's procedures reasonably safeguard cash.

The auditor should not assume responsibility for custody of cash or negotiable assets, but should insist upon the continuous attendance of a representative of the client while these are being examined. When the auditor and the client's staff have been pleasantly associated for a number of years there is a temptation on the part of the staff to go about routine business during the count and on the part of the auditor to permit this. The auditor will be wise to insist upon the presence of the client's representative throughout the count; this offers assurance that the association may continue to be pleasant. Many auditors obtain a receipt for the funds which have been turned back to the custodian after the count has been completed. If the custodian has been present during the count, he should be asked if he wishes to check it, but usually it is not necessary to obtain a receipt from him. If for some reason he has not been present, it is desirable to obtain a receipt from him after he has verified the count.

The items making up cash funds and undeposited receipts should be listed. For convenience in localizing possible differences or errors in the count, the auditor should list the amounts in bills and coins of each denomination. It is not usually necessary to count the contents of coin packages, although some auditors make test counts. Any packages opened should be returned to the cashier for repackaging. Checks on hand should be listed by date, name or number of bank on which drawn, payer, and amount; those not of recent date should be investigated. Unissued United States savings bonds on consignment, if significant in amount, should be confirmed with the Federal Reserve Bank to which the client is accountable.

All checks and undeposited receipts on hand should be deposited intact on the same or the following day, and this deposit should be controlled by the auditor until it reaches the bank. The auditor should ascertain from the bank whether any checks so deposited were subsequently charged back as uncollectible. Undeposited receipts may be traced to credits to individual customers' accounts through the cash receipts record, but this procedure is often omitted if the system of internal control is found to be satisfactory.

Petty cash funds are too frequently misappropriated. In his examination of these funds the auditor should consider the possibilities of manipulation, even though the detection of fraud is no longer his primary purpose. The prompt deposit of checks found in these funds is particularly important; they may have been placed there temporarily to cover up a shortage or irregularity and withdrawn after the examination of the fund. In the examination of a branch office petty cash fund, investigation of a manager's check therein revealed that at the year end it replaced a number of charges for gasoline sold to employees over a period of more than a year; it was withdrawn after the year end and the charge slips returned to the fund. This was certainly a procedure unsatisfactory to the home office.

Petty cash vouchers and debit memoranda included in the fund should be listed by date, payee, and amount. Vouchers not of recent date should be investigated. Proper approval should be obtained of all petty cash vouchers and debit memoranda on hand at the time of count. Although it is desirable to require approval of these before disbursement, in practice approval is often obtained at the time reimbursement of the fund is requested. Debit memoranda long outstanding, even if the original disbursements were approved, should be reviewed with someone in authority other than the custodian of the fund to determine that they are properly long outstanding. Permanent advances from petty cash funds to employees for working funds should be counted or confirmed; if large in number and relatively small in amount, test confirmation will suffice, but the test should be planned to cover large items each year and all items over a period of years.

It is not always practicable to examine branch office petty cash funds, especially when there are no other items to be examined, when details of accounts receivable are kept in the home office and when the branch has little or no inventory. If the amounts are significant a local public accountant may be employed. If they are not significant examination may be waived; the auditor, however, should request from branch office managers or cashiers confirmation of the amount and composition of their cash funds at the balance sheet date.

Totals of all petty cash and other funds should be reconciled with the general ledger at the date of the examination. When these funds are counted at a date other than the balance sheet date, the amount on hand at the time of the count should be reconciled with the general ledger balance at the balance sheet date and interim transactions should be reviewed.

The auditor should suggest reclassification at the year end of items other than cash in petty cash funds, if material in amount, in accordance with information on the petty cash vouchers.

Reconciliation of Cash in Banks.—The auditor should ascertain whether bank reconciliations have been made at least monthly throughout the period covered by his examination. If the bank accounts have not been reconciled monthly, he may find it advisable to discuss with the client the importance of these reconciliations and indicate that additional audit time is required when they are absent.

Cash in banks at the balance sheet date is usually substantiated by procedures including at least one independent reconciliation of the bank accounts by the auditor prior to, at, or subsequent to, that date. Reconciliation of bank accounts of petty cash, pay roll, and other imprest funds prior to the year end may be sufficient when internal control is adequate. Many auditors believe that when internal control is satisfactory, reconciliation of general bank accounts by the auditor at a date prior to the year end is sufficient if at the balance sheet date he reviews the client's reconciliations, confirms bank balances, and reviews cash transactions since the date of his reconciliation. Under proper circumstances these procedures are being used more and more by practicing accountants.

There are three acceptable procedures for substantiating deposits in bank at an examination date, two using the client's reconciliation at that date supported by the auditor's independent reconciliation at a later date, and one requiring the auditor's independent reconciliation at the examination date supported by examination of bank statements and paid checks at a later date without a complete second reconciliation. They are described briefly below.

Method 1. Check in detail all procedures followed by the client in making the bank reconciliations as at the examination date. Obtain bank statement and paid checks directly from the bank and make an independent reconciliation at a later date, and review and reconcile intervening cash transactions in the manner outlined under Method 3(b) and 3(c).

Method 2. Obtain bank statement and paid checks directly from the bank at the examination date; reconcile bank balance with the

records; obtain bank statement and paid checks directly from the bank as at the 10th or the 15th of the month following the examination date; make no complete second reconciliation, but use the bank statement and paid checks to account for deposits in transit, for most of the checks outstanding at the date of the auditor's reconciliation, and for information as to charge-backs, unrecorded checks outstanding, and other items affecting the reconciliation. From the bank statement and paid checks received at a date after the date of the auditor's reconciliation, (a) extract all checks dated on or before the reconciliation date and trace to lists of checks outstanding, (b) extract all checks drawn to order of or endorsed by the company or an affiliated company or drawn to the order of a bank and review accounting for both debit and credit to ascertain that the amount of cash at the balance sheet date has not been inflated, and (c) trace all items necessary to effect reconciliation at the date selected.

Method 1 requires more time than Method 2. Method 2 should be used only when the client's system of internal control is good and appears to be functioning properly.

Method 3. This method, like Method 1, is useful at a year end since it does not require the presence of the auditor in the client's office to reconcile bank accounts at, or during the days immediately following, that date. Method 3 takes less time than Method 1 and some auditors believe it affords a more satisfactory reconciliation of deposits in bank than does Method 2.

(a) Review client's bank reconciliations as at the close of the month preceding, and also as at the examination date, by comparing the balances per books and per banks as shown by these reconciliations with the corresponding amounts shown by the books and the bank statements, substantiating outstanding checks at the close of the preceding month by examination of paid checks returned by the bank in the subsequent period, and substantiating deposits in transit and other reconciling items at the close of the preceding month by reference to bank statements, bank notifications of charges and credits, and other supporting documents.

(b) Obtain bank statement and paid checks directly from the banks at some convenient cut-off date long enough after the examination date to permit the clearance of most of the checks outstanding at the examination date; reconcile the balance per bank statement with the book balance as at the cut-off date; for the period between the examination date and the cut-off date compare returned checks with the books and with the client's list of checks outstanding at the

examination date; reconcile book and bank balances of cash in banks at the examination date with the corresponding balances of cash in banks at the cut-off date in the manner subsequently described, and follow any other procedures which seem necessary under the circumstances.

(c) Check all transfers between banks just before the examination date and for the period between the examination date and the cut-off date, including banks of affiliated companies.

In making his reconciliations the auditor should determine deposits in transit at the reconciliation date by comparing cash receipts per the books with deposits per the bank statement for the period of his reconciliation and confirming deposits received by the bank subsequent to the reconciliation date. Outstanding checks at the reconciliation date should be determined by comparing paid checks received direct from the bank with the client's previous reconciliation and cash disbursements records.

Any of the above-described methods, if appropriate at the year end, may be employed when the auditor's reconciliation is made at a date prior to the year end. Reliance upon a reconciliation at a date prior to the year end, supplemented by certain procedures at the balance sheet date, presumes a satisfactory system of internal control, embodying at least the following procedures:

1. Bank balances are reconciled monthly or more frequently by an employee whose duties are independent of cash receipts, cash disbursements, and bookkeeping, preferably by a member of the internal auditing department.
2. Bank statements and paid checks are obtained direct from the bank by the employee making the reconciliations.
3. Duties of employees authorized to sign checks are independent of cashier and bookkeeping functions.

When circumstances do not require an independent reconciliation of general bank accounts at the balance sheet date, the auditor should supplement his reconciliation at a prior date by certain procedures at the balance sheet date. Usually such procedures will consist of:

1. Review of client's reconciliations by
   (a) Comparing balances per bank statements and deposits in transit with confirmations received by the auditor direct from the bank.
   (b) Comparing balances per books with books.
   (c) Proving mathematical accuracy of client's reconciliations.

(d) Obtaining bank statements and paid checks direct from the bank at a date shortly after the year end; comparing checks dated at, or prior to, the year end with checks listed as outstanding on the client's reconciliations; and tracing transfers of funds to book debits and credits which should be recorded as at the same date.

(e) Substantiating reconciling items other than those referred to under (d) above by reference to supporting documents.

2. Review of general ledger cash account, cash receipts and cash disbursements records for the period following the auditor's independent reconciliation to the year end.

The auditor's bank reconciliation under any of the three methods may include reconciliations of receipts and disbursements as well as of the balance on a form similar to the following. In this illustration it is assumed that the date of the auditor's bank reconciliation is January 15 and that in making such reconciliation he has compared paid checks returned by the bank at January 15 with entries in the cash disbursements record and has traced January deposits per books to the January bank statement.

Reconciliation of Cash on Deposit in (Name of Bank)
December 31, 19— to January 15, 19—

	Balance December 31, 19—	Receipts	Disbursements	Balance January 15, 19—
Per bank statement	$31,268.72	$42,687.50	$46,560.82	$27,395.40
Deposits in transit:				
December 31, 19—	1,000.00	1,000.00*		
January 15, 19—		2,000.00		2,000.00
Outstanding checks:				
December 31, 19—	3,916.78*		3,916.78*	
January 15, 19—			4,560.65	4,560.65*
Unrecorded charges and credits:				
Collection of Smith & Co. note credited by bank January 14 entered in books January 16		78.40*		78.40*
Bank collection charge on above note			4.80*	4.80
Per books	$28,351.94	$43,609.10	$47,199.89	$24,761.15
Audit adjusting entry #1:				
Collection of Smith & Co. note				78.40
Bank collection charge on above note				4.80*
Per books as adjusted				$24,834.75

* Indicates red figure.

The auditor should foot deposits and disbursements as shown on the bank statement to produce the amounts on the first line of columns 2 and 3; other items in these columns will be supported by details that have been substantiated by him. If the totals of columns 2 and 3 agree with footings of deposits and disbursements per the books, footing of the client's record of bank deposits and disbursements for the period will be unnecessary. The foregoing procedure, of course, does not prove that all items recorded as cash receipts have been included in amounts recorded as deposits in banks. Bank statements and paid checks should be kept under the auditor's control until his reconciliation has been completed.

Procedures for substantiating deposits in transit and outstanding checks on a bank reconciliation prepared by either the client or the auditor have been described. The auditor must assure himself that other items in the reconciliation are bona fide and not included in the reconciliation to force a balance. He must bear in mind particularly that a subsequent entry on the books which apparently offsets an item entering into the reconciliation is not necessarily proof of its correctness. It may merely switch the item to some other account. Each adjusting entry, if material in amount, must be carefully examined to determine its propriety.

The auditor should obtain directly from the bank confirmation of all balances as at the year end whether or not he makes an independent reconciliation as at that date; if he makes an independent reconciliation at a date other than the year end, he should request confirmation of balances at that date as well. It is not advisable to combine in one communication requests for information required from the bank as at two dates, unless both dates are in the past or one is in the past and the other in the immediate future. A letter mailed in December requesting information as at December 31 and January 15 may be mislaid in the bank after information as at the first date has been furnished. Information should be requested as to balances on deposit including restricted deposits, deposits in transit, items held for collection or safekeeping, other direct or contingent liabilities to the bank, and unused balances of letters of credit. The request does not usually disclose amounts to be confirmed. A form of request to be typed on the client's letterhead is illustrated on page 119.

The auditor should inquire as to the client's practice in depositing receipts and ascertain how much time normally elapses between the receipt of money and its deposit. Unreasonable time lags should be investigated. When receipts in currency are large and when receipts

(Name and Address of Bank)

Dear Sirs:

Our auditors, (name and address of auditors), are now making the usual examination of our accounts, and in this connection they have requested that you certify to them the following information:

Our balance on deposit subject to withdrawal on demand in each of the following accounts:

* *

* *

at the close of business on ...., 19—, and on ...., 19—.[1]

Amount of any time or other balance on deposit to our credit at the close of business ...., 19—, stating circumstances under which each may be withdrawn.

Statement of deposits credited to our account on ...., 19— and ...., 19—.

Statement of our liability to you, on ...., 19— (if none please so state), directly or indirectly, as makers, acceptors, endorsers, or guarantors on notes, drafts or acceptances or otherwise, giving amounts of principal, dates made, due dates, dates to which interest has been paid, interest rates, and all collateral, liens and trust receipts held, if any.[2]

Statement of any securities or items for collection or securities held by you in safekeeping or as agent or trustee, for our account at close of business ...., 19—.[2]

Unused balances of any letters of credit issued to us.

Kindly furnish this information to our auditors direct, using the enclosed addressed envelope, and at the same time advise them of any direct or contingent liabilities not stated above.

In addition, please send direct to them, together with the paid checks, the statement of the above account as at ...., 19—.

Very truly yours,

[1] Or, separate letter may be written, one for each date as to which confirmation is requested.

[2] Or, for the greater convenience of the bank, the amounts or other particulars according to the client's records may be given in the letter requesting confirmation, in which case the language of the letter would be changed slightly to make suitable reference to the details given.

are not deposited daily there are opportunities for manipulation not possible in other circumstances.

In his examination of cash receipts the auditor should be on the alert to detect lapping and kiting, two frequently used procedures for concealing misappropriation of funds. In lapping, cash received from a customer is appropriated by the cashier; at a later date cash received from another customer is credited to the first customer's account and the second customer's account is credited still later by cash received from a third customer. This delay of credits continues until it is detected, the cashier makes voluntary restitution, or it is covered up by a fictitious charge to operating accounts. If receipts are in currency, detection of lapping is difficult unless confirmation of all accounts receivable is requested. If receipts are in checks, the original misappropriation is more difficult, but not impossible, particularly if weak internal control procedures permit the cashier to control petty cash funds as well as receipts. Comparison of details of deposit slips with details of the cash receipts record may reveal the irregularity. Duplicate deposit slips in the client's file cannot be relied upon as a list of checks deposited. Banks will, upon request, furnish copies of deposit slips or permit examination of deposit slips in their files, but very few banks compare amounts of individual checks with amounts listed on the deposit slip. Checks on hand at the time of the auditor's examination may be traced through the cash receipts record to credits to the proper customer's accounts, but the cashier who tampers with receipts on the day of the auditor's count is stupid indeed. So again the auditor must rely upon confirmation of accounts receivable as the surest method to reveal lapping. Lapping is a practice most effectively prevented by proper procedures of internal control. It may be detected by the auditor, but detection is difficult unless all accounts receivable are confirmed as at the examination date, including those that have been paid between the examination date and the date the confirmations are mailed.

In kiting, a shortage in a bank account may be covered up by depositing in it and not recording in cash disbursements a check drawn on another bank; the unrecorded check may later be covered by drawing another unrecorded check on a bank other than the one on which the first check was drawn. The time required for the checks to clear through the banks may conceal the shortage for some time. The auditor can detect kiting at the year end by obtaining bank statements and paid checks directly from the banks at a date shortly after the year end and examining all bank transfers indicated by

these checks just before the year end and for the period between the year end and the cut-off date.

For the period immediately preceding the examination date the auditor should compare daily totals of recorded cash receipts with deposits per the bank statement to determine that each day's receipts are deposited intact and without unreasonable delay. Deposits in transit will have been confirmed by the bank if the form of request previously suggested is used. If the client includes in cash receipts of the period amounts that are not deposited until well into the following period, the auditor should inquire into the cut-off procedures at the period end. If the books have been held open to include receipts after the balance sheet date and these receipts are significant in amount, the auditor should insist that cash be credited and accounts receivable debited by these amounts or qualify his report accordingly.

Items on the bank statement which appear to be, or the client claims are, bank errors and corrections not so coded, and all debits or credits followed by credits or debits of identical amounts, should be examined to determine that they are actually what they are claimed to be. If they cannot be satisfactorily explained by information in the client's office, the auditor should request confirmation from the bank as to what they are. They may be irregularities that an employee is trying to conceal. If internal control procedures are inadequate, a cashier may withdraw an entire deposit from the bank on an unrecorded check and destroy the paid check when it is returned by the bank. The bank statement may then show an uncoded debit and credit of the same amount which he will claim are a bank error and its correction.

Some accountants believe that before beginning the reconciliation paid checks returned with the bank statements should be compared with amounts on the bank tapes accompanying them and that single checks, debit memoranda, and tape totals should be compared with charges on the bank statement to make sure that items supporting all debits on the bank statement are included with the bank statement. Others believe that often the time required to do this is not justified; that checks can be re-sorted later by bank payment dates and compared with amounts on bank tapes if an omission of a paid check cannot be identified otherwise.

Paid checks returned with the bank statement should be compared with the client's disbursements records for date, payee, and amount. Before beginning this comparison the auditor should determine which is the appropriate record of disbursements to use, for it is not un-

usual to find more than one. For example, there may be a check register; a check stub book or a file of duplicates of checks drawn; or there may be more than one cash book covering disbursements from a single bank account. The auditor should make his comparisons with data reflected in books of original entry, rather than with that in a summary record. If the auditor uses a summary record he must be sure that the client's procedures and internal control make this record entirely reliable. From this comparison the auditor will be able to determine which checks have not cleared the bank during the period and that dates, payees, and amounts of disbursements as shown by the paid checks are those recorded in the disbursements records.

The auditor should determine that signatures on checks are apparently those of employees authorized to sign checks. He should scan endorsements to see that they are in the name of the payee.

In his examination of paid checks the auditor must be alert to note any irregularities. He should list and investigate bank transfers, checks drawn to cash, to petty cash, to bearer, or to officers and employees other than for pay roll. Questionable items must be traced to supporting documents, for a paid check in itself is not evidence of the propriety of a payment.

Transfers of funds within an organization, whether between banks, between divisions, or between affiliates, must be examined carefully. The examination should be made preferably from paid checks and bank advices to the cash records, rather than vice versa. The auditor must determine that for the period during which cash transactions are being examined each transaction represented as being a transfer is that in fact. He should ascertain that debits and credits representing transfers of cash are recorded in the same period and that the funds were deposited in the receiving bank. If he does not, a defalcation may remain concealed.

In his reconciliation the auditor should account for all checks issued in the sequence between the first and the last checks drawn during the period.

If the auditor is in the client's office at the year end he should record the number of the last check drawn and mailed on that day. If he is not there at that time he should inquire about cut-off procedures to ascertain that the client did not draw checks on the last day of the period and hold them for delivery to debtors in the subsequent period or draw checks in the subsequent period and date them in the period under examination. A comparison of the number of checks outstanding at the end of the period with the number outstanding on

other reconciliations during the year may indicate that the books were held open at the end of the period. If checks held up or drawn in the subsequent period are significant in amount, the auditor should request that cash be debited and accounts payable credited by these amounts.

Checks outstanding at the close of the period, not returned with the subsequent bank statement, if material in amount, should be substantiated by reference to properly approved vouchers or other available documents. If they are not material in amount they should be substantiated during a later visit, probably at the start of the audit of the subsequent period, by examination of paid checks perforated by the bank at a date after that of the last bank statement received during the previous visit or by canceled checks and stop-payment orders.

As indicated in the consideration of the auditor's examination of the client's reconciliation, the auditor must attempt to determine that all items in his reconciliation are bona fide; he must remember that the propriety of reconciling items is not established by the fact that reconciliation is effected by their inclusion. Each reconciling item must be carefully scrutinized to determine that it is proper.

Examination of Cash Records.—If the auditor's reconciliation has included reconciliations of receipts and disbursements in the form previously suggested and if, for the period of his reconciliation, deposits per the bank statement have been compared with deposits per the books and paid checks with cash disbursements records, footing the deposits columns in the cash receipts records and the cash disbursements records for the period of the reconciliation are not necessary. This form of reconciliation makes unnecessary a check of postings for the period covered from these records to the general ledger cash account. The general ledger account, however, should be scrutinized and entries from sources other than cash receipts and disbursements substantiated. The cash receipts column should be footed, and if separate from the deposit column in the cash receipts book, compared with totals in the deposit column.

The auditor should inquire as to the bank's procedures in charging back uncollectible deposit and collection items. Banks dealing with businesses that deposit a large number of checks each day, by special arrangement often do not record on the bank statement dishonored checks included in deposits, but have a runner take the dishonored checks to the client's cashier each day and return to the bank with cash or a check to cover the aggregate amount of the dis-

honored paper. If this is the bank's procedure the auditor should request the bank in advance of the year end to confirm amounts charged back during the ten-day period following the year end. He must assure himself that the cashier did not cover a shortage over the year end by depositing fraudulent paper in the knowledge that such paper would be returned after the year end without record thereof appearing on the bank statement.

It is good practice to have new bank accounts of a corporation approved by an executive body such as the board of directors. The auditor should look for such approval in the recorded minutes and if it is absent suggest that it be secured. He should also look to the minutes for approval for discontinuing bank accounts. Final statements of all bank accounts closed since the last examination should be reviewed to determine that dispositions of balances were proper.

Additional Procedures.—In the preceding pages it has been the intent to indicate minimum auditing procedures in the examination of cash when the client has a reasonably effective system of internal control. Other auditing procedures may be necessary when the system of internal control is weak or when there are other reasons for an extended examination.

In addition to his reconciliation at the examination date the auditor may reconcile the bank account at an unannounced date during the year. If there is any suspicion of irregularities, an unannounced examination of cash including a bank reconciliation may reveal them.

Some auditors request confirmation by the bank of authorized signatures for client's checks. This is not usual practice, but it may reveal that persons no longer employed by the client are authorized to draw on its bank account.

If the auditor is in the client's office at that time he may examine receipts of the last few days of the period and control them until they are deposited. Items on these deposits may later be traced to credits to accounts receivable through the cash receipts record to determine that the proper customers were credited and that there was no attempt to cover up lapping during this period.

The auditor may examine supporting vouchers for, or review with an officer, checks other than pay roll with more than one endorsement. A second endorsement may indicate payment of a fictitious invoice.

For one or more months other than the last month of the period the auditor may

- Trace cash receipts per the books to prompt deposit in the bank through duplicate deposit slips obtained from the bank, realizing that since the deposit slips are not always checked as to details, including dates, by the banks, the results of this test, if favorable, are not conclusive;
- Compare recorded receipts from customers with credits to accounts receivable, computing cash discounts allowed;
- Reconcile deposits and disbursements per the bank statements to receipts and disbursements per the books;
- Foot cash receipts and cash disbursements records and check postings to the general ledger;
- Compare paid checks with cash disbursements record for date, payee, and amount, examining endorsements and bank perforations; and
- Compare cash disbursements entries with entries in the voucher register.

The list of additional procedures above is not intended to be complete. The auditor will use his judgment in determining the nature and the extent of the tests appropriate to the circumstances.

Coordination of Examination with That of Related Accounts.—Cash procedures are of value in substantiating income and expense accounts in that they indicate collections which are reflected in sales through accounts receivable and payments which are reflected in expenses. When an organization operates on a cash basis, cash procedures substantiate to some extent income and expense as recorded.

Time of Examination.—In the preceding consideration of auditing procedures of cash there has been some indication of the time of the examination. Some examination must be made at, or shortly after, the year end, but, if internal control procedures are satisfactory, much of the examination may be made prior to that date.

Prior to the year end the auditor must certainly obtain information about cash locations and procedures; he may count petty cash and other imprest funds; reconcile cash in banks for pay roll, petty cash, and other imprest funds; make many of the tests suggested under "Additional Procedures"; and, if internal control procedures are satisfactory, he may reconcile regular bank accounts and count undeposited receipts. At the year end he should review the client's reconciliations or, if internal control procedures do not permit a reconciliation at a prior date, reconcile regular bank accounts and count undeposited receipts.

STATEMENT PRESENTATION

Description of Cash.—Unless the balance sheet is being prepared for some special purpose, it is rarely necessary in classifying cash to distinguish between currency on hand, undeposited checks, cash in banks, or the location of various deposits. The description of cash in banks as "demand deposits in banks" has merit in that it removes any question of restrictions. The reader of any balance sheet has a right to assume, however, that the item "cash" is realizable in the amount stated and is completely and immediately available for the conduct of the business and the payment of debts.

Segregation of Restricted Cash.—Time deposits must be so shown. If cash on hand includes balances with trustees, such as those for sinking funds, or amounts earmarked by the management for the purchase of fixed assets or other specific purposes, the facts should be adequately disclosed on the balance sheet and proper classification made as between current and noncurrent assets.

Balances on deposit in foreign countries subject to exchange restrictions, if material in amount, should be shown separately rather than as an unidentified element of cash and the restrictions should be clearly indicated.

Cash which is not immediately available, restricted to use for other than current operations, designated for expenditures in the acquisition or construction of noncurrent assets, or segregated for the liquidation of long-term debt should be excluded from current assets. Restrictions are considered effective even though the funds are not actually set aside in special accounts if it is the clear intent of the company to observe them.

Amounts withheld from employees for payment of income and social security taxes, purchase of savings bonds and insurance, and like items require segregation from other cash only when these amounts are a substantial portion of the company's total cash and a reader of the balance sheet might be misled by failure to segregate.

Bank Overdrafts.—When there are two or more bank accounts, an overdraft in one may be offset by a balance in another bank if the debit balance used to offset an overdraft is actually free, and the company is not required to keep a minimum balance in the bank, in consideration of a loan from it or for other reasons. That part of an overdraft not offset by a free balance in another bank should be included in accounts payable.

CHAPTER 9

MARKETABLE SECURITIES

ACCOUNTING PRINCIPLES

Marketable securities are those which are salable under ordinary circumstances with reasonable promptness. Securities of affiliates and subsidiaries, since they are held for the purpose of control rather than investment, are not within the category of marketable securities, even though they may possess other characteristics of such securities.

Marketable securities form a significant part of the assets of investment companies, banks, insurance companies and institutions. In commercial and industrial companies they usually represent investment of excess funds and ordinarily do not constitute a material portion of assets nor does the income from them constitute a significant part of total income.

Basis of Recording.—Marketable securities are usually recorded in the books of account at cost. Cost includes expenses incident to

acquisition such as brokerage commissions and transfer taxes. Conversely, similar incidental expenses of sale are deducted from the selling price in computing proceeds of sale. When marketable securities are received as gifts, as they often are by educational, religious, and charitable institutions, they should be recorded in the accounts at fair value at date of gift. Fair value is usually determined on the basis of market quotations, or, if they are not available, by management appraisals. While the financial statements of many investment companies state investments at amounts based on market quotations, or management's appraisals of fair values, which in the aggregate may be in excess of or less than cost, it is not customary to record unrealized net appreciation or depreciation in the books of account. The basis of carrying investments in financial statements will be discussed later.

When securities are adjusted in the course of a reorganization, or quasi-reorganization, the adjusted amount is treated as if it were cost.

It is not customary to adjust book amounts of securities to reflect fluctuations in market values. However, evidence of a permanent decline in value should be recognized in the accounts by means of a write-down or the establishment of a reserve.

When securities have been acquired in exchange for other securities as the result of the consolidation, merger, or other reorganization of the company in which an investment is held, or as the result of the exercise of conversion privileges contained in the terms under which a security was issued, cost is considered to be the cost of the security delivered in exchange. However, if there is evidence of a permanent decline in value the security received should be recorded at the lower current value. Exchanges other than those discussed above are usually tantamount to purchases and sales, and cost of the security received accordingly should be the value of the security received at the time of receipt.

Security transactions are usually recorded as at the contract date, except for stock brokerage concerns where the settlement date is used for the recording of purchases and sales made for customers.

Sales of Holdings in Part.—There are three methods in general use for costing sales of part of an issue held; the first-in, first-out basis, on the basis of the cost of the specific certificates delivered in the sale, and on the basis of average cost. The average cost method has the merit of recognizing the fungible character of different lots of the same security and is considered preferable to the other two

methods. A preference for the average cost method is evident in the following quotation from Regulation S-X promulgated by the Securities and Exchange Commission: Rule 6.05(d)—"State the basis followed in determining the cost of securities sold. If a basis other than average cost is used, state, if practicable, the gain or loss computed on the basis of average cost." However, any of the three methods of computing realized profits or losses is generally accepted accounting practice provided the change in unrealized net appreciation or depreciation of investments during the period reported upon is clearly indicated. Under present regulations of the Treasury Department, the average cost basis may not be used for federal income tax purposes. Disclosure of the change in both realized and unrealized profits and losses on investments and consistency of method of computing realized profits and losses are of more importance than the choice of method by which they are determined. The identified cost method, although permissible, is obviously not as objective as other methods and permits considerable variation in recognized gain or loss at the option of the vendor. However, the aggregate or net amount of both realized profits and losses and the change during the period in unrealized net appreciation or depreciation will always be the same regardless of which of the three methods is adopted.

Amortization of Bond Premiums and Discounts.—When bonds are held as long-term investments for income, as they often are by insurance companies, trusts, institutions, and certain investment companies, premiums paid are generally amortized by periodic charges against income received on these bonds, since the indicated loss which will be realized if the bonds are held to the redemption date is in effect a reduction of interest received to the effective rate. The premium is usually absorbed in the period between the date of acquisition and the earlier of maturity or optional call date.

Bonds purchased at a discount are not usually written up by periodic adjustments to the amount at which they are redeemable. Discount should be amortized only when the bonds are high grade and the discount represents an adjustment of interest rate rather than doubt as to the ultimate realizability of the obligation.

Arrearages of Income.—The cost or other basis of bonds with interest in arrears at date of acquisition, or preferred stocks with arrearages of cumulative dividends, should be reduced upon receipt of these arrearages to give recognition to the fact that the original book amounts included an element of accrued income. Opinions differ as to what portion of this income should be credited to the

book amount of the security. The indicated market value of the bonds or preferred stock, or the trend of such values at the time the income in arrears is received, may well be a factor to be considered, since if the original investment may be expected to be recovered without loss, a credit to income for the amount in arrears may be appropriate, but if a loss is likely, conservatism indicates that the asset account should be credited. Rule 6.04 of Regulation S-X issued by the Securities and Exchange Commission states in paragraphs (d) and (f) in part the following:

> (d) Dividends in arrears on preferred stock may not be treated as income in an amount which exceeds an amount arrived at by applying the stated dividend rate to the period during which the stock has been held. . . . Any such dividends which are treated as income but which are applicable to periods prior to the current fiscal year shall be included under the caption ("other income").
>
> (f) Due consideration shall be given to the propriety of treating, as income, interest received on bonds which were in default when acquired. Any such interest which may be treated as income shall not be treated as ordinary interest income in an amount in excess of the amount arrived at by applying the stated interest rate to the period of report, and any excess thereof shall be included under the caption ("other income"). . . .

Contingent Interest on Income Bonds.—When income bonds with interest payable only if earned are not owned for the entire period for which the interest is being paid, income should be credited with that portion of the total interest received which corresponds with that part of the interest payment period for which the bonds were owned, and the asset account should be credited with the balance. Interest should be accrued on income bonds only if earnings of the debtor corporation are sufficient to indicate that the interest will be paid. In practice, however, income from these bonds is usually not material in relation to total income, and such interest is generally taken into income on the date declared payable, in spite of the fact that the bonds may not have been owned for the entire interest payment period.

Stock Dividends.—When a dividend on common stock is received in the form of shares of the same common stock the effect is merely to increase the number of units of ownership without any increase in the stockholder's proportionate ownership in the issuing company or any effective divestment of property or rights on the part of the company. Under these circumstances no income is deemed to have ac-

crued to the stockholder and the cost of the original shares is apportioned between those shares and the new shares received.

When dividends are received on common stockholdings in the form of preferred shares of the issuing company and when other shares of the same or similar preferred stock are outstanding, it has been held in certain income tax cases that income has been received because the dividend gives the stockholders an interest different from that which his former holdings represented. While this treatment may have merit because of special provisions in the Internal Revenue Code, it is the authors' opinion that such stock dividends are so similar in characteristics to dividends received in stock of the same class as that held that it would generally be preferable to accord them the same accounting treatment and to apportion costs between the stock received and the original stock held rather than to credit the fair market value of the dividend to income. It should be noted that dividends paid in preferred shares to common stockholders when no preferred shares were previously outstanding do not result in a change in relative interest and such dividends under any circumstances should not be considered as income. Likewise, dividends paid in shares of a junior preferred stock to common stockholders when no junior preferred stock was previously outstanding should not be considered as income.

Dividends consisting of shares of stock of a company received as the result of ownership of shares of another company, commonly termed "in kind" dividends, represent the receipt of property and are tantamount to the receipt of cash dividends. Accordingly, they should be credited to income at their fair market value, provided that they have been paid from accumulated earnings of the paying company. If these dividends are not paid from accumulated earnings, the cost of the shares on which the dividends are received is ordinarily apportioned between the original shares and the shares received as a dividend on the basis of their relative fair market values.

Stock Rights.—The considerations as to whether or not receipt of stock rights constitutes income should be the same as those employed in making such determination with respect to stock dividends. See discussion under Stock Dividends.

Optional Dividends.—When a corporation which declares a dividend gives stockholders the option of taking stock or cash, a situation arises which has led some to argue that, if the investor elects to take stock, the stock dividends should be considered as income in an amount equal to the cash which the stockholder would have received

had he so elected. A stockholder who is given the option of taking a dividend in cash or in stock is being given a choice between obtaining funds (which he may consider as income on his present holdings) or increasing his shareholdings (and perhaps by reason of other stockholders electing to take cash, increasing his equity) in the corporation. The authors see no good reason why the privilege of taking a certain amount of cash in lieu of stock should make it proper or desirable to consider that the unaccepted offer of cash gives the stock dividend a status different than that of an ordinary stock dividend. Furthermore, a corporation which gives the stockholder the choice of a cash dividend or a stock dividend usually makes the offer so that the choice of stock appears more advantageous to the stockholders. Ordinarily, a majority of the stockholders avail themselves of such an opportunity to acquire stock. The result, therefore, is usually practically the same as if an ordinary stock dividend had been declared.

INTERNAL CONTROL

Good internal control of marketable securities is effected primarily by the segregation of duties between those having custody of the securities and those maintaining the accounting records.

Authorization for Transactions.—Authority for the purchase, custody, and sale of marketable securities should be clearly defined. Changes in investments should be authorized or approved in the minutes of the meetings of directors or trustees.

Records.—A detailed record of each security showing, in addition to the number of shares of stock and the principal amount of bonds and their costs or other basis, a complete and accurate description including certificate numbers, should be maintained by accounting department employees not having access to or control over the physical securities. A detailed record of income receivable or accrued should also be maintained either as part of the foregoing record, or separately, and a check should be made periodically to ascertain whether all income receivable or accrued has been recorded. Both the cost or other basis of marketable securities, as well as the income receivable or accrued, as shown by detailed records, should be balanced periodically with general ledger control accounts.

Custody.—When marketable securities are kept in a safe deposit box or vault under the control of the company it is desirable that

access thereto should be vested jointly in at least two or more responsible employees, with the provision that when only two persons have access at one time, at least one of them shall be an officer of the company. Employees and officers having access to the securities should not participate in the maintenance of accounting records. They should keep a record of deposits and withdrawals for periodic comparisons with authorized purchases and sales of securities; these comparisons should be made by a responsible employee who does not have access to the securities and whose duties are independent of accounting records.

Securities should be registered in the name of the company or an accredited nominee. When, however, circumstances make it necessary or expedient to register securities in the name of an individual the certificates should be promptly endorsed and an assignment of income obtained.

Separation of bond coupons, warrants and the like, should be subject to the same general safeguards as the withdrawals of securities.

Securities held as collateral or for accommodation should be kept under accounting control and procedures for their deposit or withdrawal should be the same as for securities owned by the company.

Securities Deemed Worthless.—At times investment securities held are deemed to have little, if any, recoverable value and, therefore, are either written off the books, carried at a nominal amount, or reserved in full. These securities should be under adequate control and they should be reviewed periodically as to possible increase in value.

Periodic Inspection.—At regularly stated intervals an accounting department representative or internal auditor, together with individuals authorized to have access to the vaults, should make a complete inspection of securities, comparing them with accounting department records. Securities which are not on hand should be confirmed with the holders.

AUDITING PROCEDURES

Objectives.—The auditor must satisfy himself that marketable securities shown by the accounting records to be owned as at the date of the balance sheet were on hand as at that date, or if not on hand, were held by others for the account of the client. He should also ascertain that the cost or other basis at which the marketable securities are carried in the accounting records is in accordance with

generally accepted accounting principles and that the description of marketable securities as shown on the balance sheet is fair.

Review of Internal Control.—The auditor should review internal control procedures, so that the audit emphasis may be directed to indicated points of weakness.

Simultaneous Examination.—Marketable securities owned or held as collateral or for safekeeping should be counted simultaneously with cash funds, undeposited receipts, notes receivable, and other negotiable paper, in order to prevent substitution of one for the other.

Count of Securities.—When the portfolio of marketable securities is relatively large and active, as in banks, insurance companies, investment companies, and stock brokerage concerns, the count of securities will ordinarily be made at the balance sheet date. When the holdings of marketable securities are incidental to the principal business of the concern and are relatively small and inactive, the count may be made before or after the balance sheet date provided the auditor establishes and maintains control of the securities in the intervening period by arranging to have them placed under seal for the period between his count and the balance sheet date. If the internal control procedures are weak and the cashier has access to notes receivable and marketable securities, the auditor who is making a bank reconciliation at a cut-off date soon after the end of the fiscal period should count cash funds, undeposited receipts, notes receivable, marketable securities, and other negotiable paper at the same date in order to be assured that there has been no substitution. Whenever the count of marketable securities is made at a date other than that of the balance sheet, the details of the items counted should be reconciled with the items shown by the records to have been owned as at the end of the fiscal period.

The auditor should maintain control over all marketable securities from the start of his count until the count has been completed and checked to the list of securities, and all exceptions have been investigated and satisfactorily adjusted. When marketable securities are relatively few, inactive, and kept in one location, the auditor has no special problem of control, but when opposite conditions prevail, as in concerns whose principal assets are marketable securities, the auditor must exercise care not only in determining the most expeditious plan of count, but also in setting up his controls with the least inconvenience to the client. At the outset of the examination of marketable securities, especially if the examination is being made without prior notice to the client, the auditor should immediately

ascertain the locations of all marketable securities, establish controls at the various points necessary in order to record any movements of securities, and determine the sequence of count of the various items.

All counts of marketable securities should be made in the presence of responsible officials or employees of the client. A list of all marketable securities owned or held as collateral, or for safekeeping, as at the date of the count should be prepared from the security records by the client or the auditor. The count of securities on hand should be checked against this list, which should show adequate descriptions of the securities, including the aggregate principal amount of bonds and notes, the number of shares of stock, denomination of bonds or par value, if any, of stocks, maturity dates of bonds, and interest and preferred stock dividend rates. As previously stated, certificates of stock and registered bonds should ordinarily be in the name of the client or an accredited nominee but, if they are not, the certificates should be appropriately endorsed or should be accompanied by powers of attorney. Whenever bonds have interest coupons attached, the auditor should make at least a test examination of these coupons to determine whether there is any indication that coupons not yet due have been detached. If coupons presently coming due do not accompany the bonds, the auditor should inquire as to their location, and should either inspect them, or confirm them with those to whom sent. If coupons past-due are found to be on hand, the auditor should ascertain why they have not been presented for payment. If interest is in default, the auditor should note this fact in his working papers and consider it in connection with his examination of accruals of income and carrying amounts of investments.

After groups of securities have been counted, they should be kept under the auditor's control until the count has been completed and all items on the list of securities have been examined or reconciled. If any movement of securities is necessary before the count is completed, the auditor should observe the withdrawal or deposit of the items, ascertain the reason for withdrawal, and record the facts in his working papers. Securities taken to be mailed to correspondents, brokers, transfer agents, or others, but which were included with securities already counted by the auditor, should be recorded by him and controlled until they are turned over to the postal authorities. If these securities are to be in transit over the audit date, this record will also be needed for purposes of reconciliation. Securities received by the client through the mail for a few days subsequent to the date of examination may also be examined and a record made for convenience in substantiating items in transit at the date of the audit.

Relatively inactive and apparently worthless securities can be counted and placed under seal in advance of the main count or placed under seal and counted after the more active items have been examined. When securities remain unchanged over several years, certificate numbers of representative items noted during the count may be compared with the certificate numbers of the same securities as shown in the working papers of the previous audit. Securities have sometimes been sold without proper authorization and record, immediately after an examination and replaced before the beginning of the next examination. Securities deemed to be worthless should be examined by the auditor even though they are no longer shown on the accounting records or are carried at a nominal amount. The auditor should ascertain what attempts have been made by the client to sell or otherwise dispose of them for value. If the client feels that a potential value still exists, the auditor should recommend that a proper accounting record of these securities be maintained.

When examinations are being made of one or more of several accounts of trusts handled by the same trustee or in the same office, the auditor should count securities for all trust and other accounts simultaneously. Similarly, if different auditors are employed to examine the several accounts, they should make their counts simultaneously. Otherwise, shortages may be concealed by temporary transfers from accounts whose securities are not being counted. When the client is reluctant to permit the auditor to count the securities of the other accounts, or is unwilling or unable to arrange for a simultaneous count by all the auditors concerned, the auditor may identify securities owned by the client by accounting for certificate numbers of stocks and bonds.

The possibility of substitution also applies to situations where the treasurer or other official of the client's organization in charge of securities may hold a similar position in a charitable, educational, or social organization. The auditor should not overlook the possibility of substitutions, especially when there are weaknesses in internal control procedures such as absence of dual control of access to securities in a vault or other uncontrolled access to securities.

Confirmation of Securities Not on Hand.—Items on the list of marketable securities owned as at the audit date but not counted should be confirmed with those by whom held. These items will ordinarily include securities held by banks as collateral for loans or for safekeeping, securities with transfer agents and, if the client is a stockbroker, items with other brokers on loans or awaiting deliv-

ery. The auditor should determine not only the location of these securities as at the examination date, but also why they are held by others. Confirmation requests, if prepared by the client, should be compared with the security records by the auditor, who should mail the requests on the date of the count or as soon thereafter as feasible, in envelopes bearing his name and address either printed thereon or corner stamped. A return envelope addressed to the auditor should be enclosed to facilitate a reply. If an unsatisfactory reply is received, the auditor should make a complete investigation and obtain a full and satisfactory explanation of any reported differences. If no reply is received to initial requests for confirmation, second requests should be mailed and the items in question should be followed up until confirmations are received or the securities are otherwise accounted for satisfactorily.

Contracts for the purchase or sale of securities on a when, as, and if issued basis should also be confirmed by the auditor.

Securities with Outside Custodians.—When outside custodians, such as trust companies, have custody of the client's entire portfolio, the custodian should be requested by the client to furnish directly to the auditor a list of securities held for the client at the balance sheet date. The auditor should compare this list with the client's security records and account for any differences. If the custody of securities is under the control of any person or group of persons taking an active part in the management of the client, the auditor is not justified in relying solely on written confirmation from the custodian; he should employ auditing procedures outlined above relative to the examination of marketable securities in the custody of the client.

Comparison of Count with Records.—If the list of securities owned or held as collateral or for safekeeping as at the date of the count is prepared by the client, the auditor should compare it in detail with the accounting records, both as to quantities and dollar amounts. After checking the addition of dollar amounts, the auditor should compare the total with the general ledger control accounts.

Examination of Security Records.—The auditor should ascertain that the accounting record of units and related dollar amounts of securities owned as at the beginning of the period under audit is in agreement with the amounts shown in his working papers of the previous examination. Subsequent entries affecting either units or dollar amounts, or both, should be substantiated by reference to original documents, such as brokers' advices of purchases or sales,

conversion privileges, notices of stock dividends, rights issued, exchanges, calls, bank advices, and the like, or by computation as in substantiating realized gains and losses and amortization of bond premiums. The auditor should also ascertain that security transactions have been approved by the Board of Directors or Trustees or by officials designated by these boards. Usually all transactions should be substantiated, but a representative test check may suffice when the internal control procedures are satisfactory and apparently effective and the volume of transactions is relatively large, such as in banks and insurance companies. Security transactions should also be checked to or reconciled with related cash receipts and disbursements.

Determination of Income from Securities.—By reference to published services for dividends and rights and by computation for bond interest, the auditor should determine that all income from securities, receivable or accrued, has been taken up on the accounting records. This examination should be made in detail unless the client's system of internal control is such that a test check is deemed adequate.

Examination of Balances at Cost.—The auditor should satisfy himself that the costs at which securities are shown as at the balance sheet date are correctly determined in accordance with generally accepted accounting principles.

Examination of Balances at Market Quotations.—Whether marketable securities are carried on the balance sheet at amounts based on market quotations or at cost with the amount at market quotations stated parenthetically or by footnote, the auditor should satisfy himself that the amount at market quotations is fairly stated. Market quotations usually represent last sale prices on the balance sheet date or, in the absence of sales, either the last bid price or the average of the last bid and offered prices. Sometimes, particularly for special purposes, other bases, such as sales within a range of dates proximate to the balance sheet date may be used. It is the auditor's responsibility to form his opinion as to the fairness of the basis selected by the company. In addition, the auditor should check the accuracy of the company's calculation of the amount of investments at market quotations. Prices used by the client should be checked by the auditor to published sources; if a published market price of a particular security is not available, the auditor should obtain direct confirmation of the price used by the client from brokers

or other competent persons, preferably from more than one source, if available. All footings and extensions involved in the determination of the total amount of investments at market quotations should be checked by the auditor. In checking market prices, it is preferable to refer to a publication other than that used by the client to guard against the possibility of obtaining incorrect prices because of typographical errors.

It should be recognized that the amount of securities at market quotations is merely an indication of value. Indication on a balance sheet of the amount at market quotations is not intended as assurance that the securities could necessarily be sold at the indicated prices. When blocks of securities are large and the available market quotations are for relatively small quantities, consideration should be given to the need for appropriate disclosure in the financial statements to indicate that amounts at market quotations should not be construed as representations of realizability at such quotations of the blocks of securities held.

When the amount of securities priced at market quotations is in excess of cost, the auditor should consider the necessity of stating the amount of taxes or expenses which would be incurred if the securities were disposed of at the indicated amount to obviate any implication that the entire amount of unrealized gain would be an increment to surplus. Ordinarily, commissions, transfer taxes, and similar expenses are not of sufficient significance to require consideration. However, federal and state taxes on gains may be material in amount and, if they are, appropriate allowance or provision for them should be made as a reduction of indicated unrealized gain. It is not contemplated that this rule should be applied to casual holdings of marketable securities by industrial companies. Rule 6.02-9 of Regulation S-X of the Securities and Exchange Commission applying to Management Investment Companies specifically covers this point with respect to federal income taxes, as follows:

> Appropriate provision shall be made, on the basis of the applicable tax laws, for Federal income taxes that it is reasonably believed are, or will become, payable in respect of (a) current net income, (b) realized gain on investments and (c) unrealized appreciation on investments. The company's status as a "regulated investment company" as defined in Supplement Q of the Internal Revenue Code as amended shall be stated in a note referred to in the appropriate statements. Such note shall also indicate briefly the principal present assumptions on which the company has relied in making or not making provisions for such taxes.

Coordination of Examination with That of Related Accounts.—Other items of the balance sheet and statement of income which may advantageously be substantiated concurrently with the examination of marketable securities include:

Accrued interest
Dividends receivable
Interest income
Dividend income
Gain or loss on disposal of securities

STATEMENT PRESENTATION

Statement of Basis.—The basis on which marketable securities are carried in the balance sheet should be clearly indicated. Commercial and industrial companies generally carry marketable securities at cost.

Investments representing temporary allocations of funds, properly classifiable as current assets, should ordinarily be stated at market, if market is lower than cost. It is preferable to absorb in current income unrealized losses representing the difference between market price and cost. It is acceptable, however, to establish a reserve by charge to earned surplus; when this procedure is followed, a transfer should be made from the reserve to surplus for the amount applicable to any securities sold and the realized loss (or gain) should be included in current income.

Under some circumstances it may be sufficient to state the amount of the securities at market quotations as a parenthetical note in the balance sheet caption. When it is not intended to dispose of the securities in the near future, many concerns object to adjusting the books to what may represent a temporary condition but do not object to the disclosure of the amount of securities based on current market quotations. There is much to recommend this procedure, especially if market quotations are fluctuating considerably. However, when the securities are included in current assets and total cost exceeds the total amount at market quotations by a material amount a reserve for the indicated shrinkage should be provided, particularly when there is evidence of a permanent decline in values.

In financial statements of investment companies marketable securities may be stated either

(a) At cost, with the amount of the securities at market quotations indicated parenthetically or otherwise, or

(b) At market quotations, with cost indicated parenthetically or otherwise.

In financial statements of companies such as dealers in securities where securities constitute so-called "stock in trade," securities on hand are usually carried on the balance sheet at cost or market whichever is lower. When securities are carried on this basis, the amount at market quotations should be indicated parenthetically or otherwise.

It is the general practice of stockbrokers, in their published balance sheets, to carry securities in investment and trading accounts, including "short" position (securities sold, but not yet purchased) at amounts based on market quotations without disclosure of costs or, in "short" positions, without indication of proceeds of sale.

The necessity for making appropriate allowance or provision for taxes which would be incurred upon realization of unrealized net appreciation and for other material expenses of realization when the market amount of securities is indicated has been previously discussed. When securities are carried in the financial statements at amounts based on market quotations, a provision for these taxes and expenses should be shown on the liability side of the balance sheet or the amount of these taxes and expenses should be deducted from the indicated amount based on market quotations with disclosure that this deduction has been made. When the amount at market quotations is shown parenthetically or in a note to the financial statements the amount of these taxes and expenses should be disclosed in the parenthetic reference or footnote.

In order to provide the means for adequate consideration of financial statements of an investment company, a detailed list of investments should accompany their balance sheets. This list should show, as a minimum, name and class of security, number of shares of stock or principal amount of bonds held, and individual amounts at market quotations to support the aggregate amount of securities at market quotations shown on the balance sheet.

Classification as Current or Noncurrent.—In the balance sheets of commercial and industrial companies marketable securities are properly included with current assets even though there is no present intention of disposing of them within one year from the balance sheet date. However, if the securities are held for special purposes, such as for sinking fund requirements or for costs of expected plant additions, so that they are not part of the company's working capital, they should be separately shown among noncurrent assets with an appropriate indication of their intended use.

Balance sheets of investment companies, banks, and insurance companies do not customarily classify assets as current or noncurrent.

Other Considerations.—When marketable securities have been pledged or deposited, this fact should be disclosed on the balance sheet. The balance sheet treatment of United States Treasury Savings Notes is discussed in Chapter 16.

CHAPTER 10

RECEIVABLES

Receivables usually are indications of sales of either services or merchandise. Notes and acceptances receivable are formal evidence of amounts receivable, perhaps more readily negotiable but not necessarily more collectible than receivables on open account. Acceptances are a means of extending credit to a buyer. They are drafts across the face of which the drawee has written the word "Accepted" with the date and his signature, giving it the same legal status as a promissory note. Trade acceptances are noninterest-bearing time drafts, drawn by the seller on the buyer, accepted by the buyer, and payable at a designated place at a specified time, usually given only in exchange for merchandise bought in the regular course of business. Bank acceptances are time drafts drawn on a bank by either the seller or the buyer and accepted by the bank. Both forms of acceptances are negotiable and can be sold at a discount to provide funds in advance of maturity date. The primary obligation falls on the maker of a note and on the acceptor of an acceptance.

Receivable balances represent claims against customers and others,

usually collectible within the normal operating cycle of the business. Sales on the installment plan frequently are made under a conditional bill of sale with the title retained by the seller until the price is fully paid. Serial notes in the amount of the sales price may be received and the merchandise sold may be pledged against these notes.

ACCOUNTING PRINCIPLES

Cut-Off at End of Period.—Receivable balances from customers usually should include only charges for services performed or merchandise shipped on or before the balance sheet date, and similarly should reflect only credits for payments received, allowances made, or merchandise returned on or before that date. Customers may authorize billing and request that merchandise be held for future delivery. Such billings properly may be recorded as receivables, provided the merchandise is excluded from inventory. With this exception, unfilled orders of trading or manufacturing concerns are not considered to be receivables even though the goods are on hand and may be regarded as awaiting delivery.

Accounts receivable are usually recorded when title passes from the seller to the buyer; title ordinarily passes when merchandise is shipped to the customer. Exceptions are shipments f.o.b. destination when title does not pass until the buyer receives the merchandise, and shipments on drafts accompanied by bills of lading when title does not pass until the drafts are paid. It is nevertheless customary to record an account receivable at the time such merchandise is shipped. Special limitations on passing of title under installment selling plans do not preclude recognition of the transaction in recording accounts receivable when the merchandise is shipped.

The terms of contracts such as those covering long-term construction may provide for interim billings for work partially completed. If the work is proceeding satisfactorily, and if it is apparent that profit will be realized, it is permissible to book accounts receivable and take credit for the applicable profit, on the portion of the work completed and billed.

Receivable balances arising from claims other than for services performed or merchandise shipped, also should include only the charges and credits applicable up to the balance sheet date. These balances may represent income receivable such as interest, dividends, or rent, and miscellaneous claims such as those against officers and employees, transportation companies, insurance companies, and miscellaneous debtors.

Basis of Recording.—Receivable balances should be reflected in the books of account at amounts not in excess of estimated net realizable amounts. Periodic adjustment of these accounts to their estimated realizable amounts is necessary so that costs or expenses will reflect losses or diminution of balances in the period to which they are applicable. Adjustment is made by means of allowance accounts such as those for doubtful accounts, cash discounts, returns and adjustments, collection expenses, finance charges, and loss on foreign exchange.

An allowance for doubtful accounts receivable should be provided if losses on receivables reasonably can be expected. It is not always possible to identify the particular accounts as to which losses will occur but it is reasonable to make an over-all allowance based on past experience and current conditions. Frequently this allowance is provided regularly in an amount representing a stated percentage of sales. Such a basis must be reviewed periodically, as the percentage employed may not reflect current conditions, especially in a period of abnormal business activity. Whether the allowance provided as a percentage of sales is too large or too small cannot be determined until the probable collectibility of the receivable balances has been ascertained from analysis and review of the accounts. When the percentage is based upon experience covering a long period of years, the balance of the allowance account will usually be large in prosperous times when bad debt losses are low; and conversely in less prosperous periods. If no allowance based on a percentage of sales is set up regularly, then it is customary to provide an allowance as at the balance sheet date in an amount determined after study of the apparent collectibility of the receivable balances, both current and overdue, as indicated by an aging of the accounts and information regarding the debtors' ability to pay. Due consideration should be given to events after the close of the fiscal year which have a bearing on the collectibility of the accounts.

Uncollectible receivables should be excluded from both the asset account and the allowance for doubtful accounts receivable. Receivable balances written off in whole or in part, and subsequent collections thereon, if any, should ordinarily be debited or credited, respectively, to the allowance account, if there is one, or to income, if there is not.

The right to repossess merchandise does not remove the probability of loss from bad debts on installment accounts receivable balances. Much of the merchandise sold on the installment plan, if repossessed, either has no resale value as is, or, if reconditioned,

cannot be sold at a price sufficient to cover the unpaid account, cost of reconditioning, and reselling expense.

Allowance should be made at the end of the fiscal period for any material amount of cash discounts which experience and the terms of sale indicate may be deducted by debtors in settlement of their accounts. When uniform discounts are the rule, provision may be made by application of an estimated percentage to the receivable balances, which percentage should reasonably provide for these discounts on an over-all basis.

If it appears that unusual amounts of merchandise will be returned in the ensuing fiscal period, allowance for these returns should be set up to eliminate the profit previously taken when sales of this merchandise were recorded. Furthermore, consideration should be given to the necessity for an allowance covering possible rebates and adjustments because of price adjustments, defective materials guaranties, or for other reasons.

It is not necessary to make allowance for routine collection expenses. In respect of installment accounts the expenses of the collection department may be large enough to justify such an allowance. However, the finance charges which are added to sales prices of merchandise when installment accounts receivable are booked usually include adequate provision for collection expenses. If these finance charges are apportioned, so that credits to income are related to collections on installment receivables, the amount of finance charges deferred as at the balance sheet date can be considered as an allowance against the receivables, in lieu of a specific allowance for collection expenses.

Receivable balances which are to be settled in a foreign currency should be translated into United States dollars at appropriate rates of exchange in effect at the balance sheet date. Unrealized loss on translation should be charged to the income account and unrealized gain usually should be credited to a reserve for foreign exchange adjustments. However, unrealized gain may be credited to income insofar as it arises from recovery of the exchange rate from a level to which the accounts receivable had been written down previously.

INTERNAL CONTROL

Custodianship of Notes and Acceptances Receivable.—Effective procedures for internal control of notes receivable are directed to the safekeeping of the notes as well as to the elimination of record-keeping errors. The custodian of notes or acceptances receivable and

related collateral, if any, should be an employee whose routine duties are such that he does not have access to the general accounting records, particularly the cash and receivable records. Inability to control both the document representing the asset and the record will reduce opportunities for manipulation of the record and misappropriation of the asset.

Endorsements of Partial Payments.—Partial payments should be endorsed on notes receivable so that the notes will show the reduction in the face amount.

Approvals of New Receivables.—An authorized employee should approve new or renewed notes receivable, before acceptance, and the opening of new accounts receivable. Ordinarily, the credit department has this function.

Separation of Duties.—The credit department, both in approving new accounts and in following up on unpaid balances, should be separate from and independent of both the sales and record-keeping departments. The duties of those keeping receivable records should be divorced completely from cash or credit functions. Inability to control both the debit and credit sides of an entry reduces possibilities of irregularities.

Duties of receivable bookkeepers should be rotated. All employees should be required to take vacations. A bookkeeper too interested in his job to take a vacation may be a potential liability rather than an asset.

Balancing with Control Account.—Totals of the individual accounts should be balanced at least monthly with the respective general ledger control accounts, so that discrepancies may be located more easily and promptly, and the reasons ascertained. It is desirable that the individual accounts be posted by an employee other than the one who posts the general ledger control accounts, so that one record will act as a check on the other. The individual accounts should be posted from the original media, such as charge tickets, invoices, or shipping documents rather than from lists prepared outside the department. General ledger control account entries should not originate in the accounts receivable department.

Periodic Statements to Debtors.—It is a good practice to send monthly or other periodic statements to all debtors, not only to accelerate remittances but also to inform debtors of amounts owed as shown by the creditor's records. It is good internal control pro-

cedure to have these statements checked to the receivable ledgers and mailed by someone other than the receivable bookkeepers or cashier. If statements are not sent to certain debtors, this practice should be authorized and the reasons for not sending statements recorded.

Confirmation of Receivable Balances.—Unpaid receivable balances should be confirmed periodically by employees independent of the credit department, cashiers, and receivable bookkeepers. If periodic statements are the exception rather than the rule, the scope of the confirmation requests should be extensive.

Items in Dispute.—Disputed items should be handled by someone other than the receivable bookkeepers and cashier, so that adjustments, if necessary, will originate with an employee outside the bookkeeping department. Credits to accounts receivable other than through cash, and payments of credit balances should be approved by an authorized official. Numerical control of credit memoranda is desirable so that their use may be safeguarded. Customers' complaints and disputes afford management an excellent opportunity to check the effectiveness of procedures and controls.

Aging of Receivables and Control of Receivables Written Off.—Unpaid receivable balances should be aged periodically. An authorized official should review delinquent accounts and authorize any write-offs. Unless delinquent accounts and write-offs are adequately controlled subsequent collections may be misappropriated.

Postdated Checks.—Postdated checks may be kept under accounting control by use of a debit account with a contra credit account in the general ledger or they may be kept under memorandum control by recording them in a tickler file, or noting their receipt on the accounts receivable ledger. Postdated checks should be in the custody of someone other than an accounts receivable bookkeeper.

AUDITING PROCEDURES

Objectives.—Auditing procedures with respect to receivables should be sufficiently comprehensive to enable the auditor to form an opinion as to the authenticity and probable collectibility of receivable balances, and the fairness of the description and classification of these balances on the balance sheet, and to bring to his attention any contingent liability arising from the discount or sale of notes or accounts receivable. They may reveal embezzlement or kindred

frauds, but the detection of defalcations is not usually their primary purpose.

Auditing procedures will, of necessity, vary according to specific situations, as will the application of those procedures which are generally recognized as desirable. After review and consideration of internal control procedures, the number and size of individual account receivable balances, and the relative importance of total receivables as compared with other assets, auditing procedures necessary in the specific situation can be determined. Generally accepted procedures are indicated in the paragraphs which follow, but it is improbable that all of them will be necessary or desirable in most examinations.

Notes and Acceptances Receivable.—The auditor should determine, either by physical inventory or correspondence, the existence of the notes and acceptances receivable, and related collateral, if any, appearing on the client's records as at the balance sheet date. The physical inventory of notes and acceptances receivable and related collateral should be simultaneous with examination or count of cash funds, undeposited receipts and other negotiable assets. Procedures similar to those described for marketable securities should be followed, where applicable. The physical inventory of the less active of these items may well take place prior to the balance sheet date provided they are placed under seal over the end of the fiscal period. In addition, dollar balances of notes and acceptances receivable accounts should be substantiated by direct correspondence with the debtors either in detail or on a test basis, as considered necessary or desirable in the circumstances.

The physical examination of the negotiable paper on hand should include the names of makers, payees, and acceptors, dates, amounts, interest rates, maturities, endorsements, and complete details of collateral. The auditor should make a record of all these items, if such a record has not been supplied by the client in advance. Ordinarily, every note and acceptance should be seen, but, if the volume on hand is very large, and internal control procedures are reasonably complete and effective, a test by partial physical inventory of the notes may be sufficient. Negotiable paper may not be available for the auditor's inventory because it is:

Held by a bank or other agent for collection,
Discounted or sold with guaranty,
Pledged as collateral,
Collected in full, or
Renewed, with or without partial collection.

The auditor can usually obtain confirmation or acknowledgments in respect of the first three categories of notes not on hand by correspondence. It may be desirable to supplement the confirmation of notes and acceptances discounted or sold by review of cash receipts records, including duplicate deposit slips, bank notifications, and other evidence supporting their discount or sale. Similar evidence should be examined in respect of notes collected before the physical inventory of notes and acceptances.

When notes have been renewed in full, no entry may appear on the books, although good practice indicates the advisability of entries reflecting such transactions. Renewal notes, whether the original notes were renewed in full or in part, should be available for the auditor's examination.

In addition to auditing procedures as outlined, a test of the records of receipt and disposition of negotiable paper during the period under review may be desirable. The extent of any such test should be determined after consideration of the relative importance of these assets, and the number and size of individual notes. If internal control procedures are reasonably good, this examination of transactions of the period may be unnecessary.

Accounts Receivable.—Procedures for examination of accounts receivable include, in addition to confirmation by direct communication with the debtors, review and checking of controlling accounts, trial balances of individual accounts and aging analyses, and examination of related supporting evidence.

General ledger control account balances should be compared with totals of individual accounts receivable and any discrepancies between the two should be investigated and appropriate adjustment should be made by the client. Trial balances of accounts receivable prepared by the client (often on adding machine tapes) should be checked to the individual ledger accounts in detail, or, if internal control procedures are satisfactory, on a test basis. Trial balance footings should be checked to the extent deemed appropriate.

General ledger control accounts covering receivable balances should be reviewed for all or part of the period under examination to ascertain whether there are any entries unusual in amount or source. This procedure should be followed especially when it is not the practice of the concern to balance regularly the total of the individual accounts with the respective general ledger control accounts. The auditor should not overlook the possibility that an entry unusual in amount or source may be made in a subsidiary record, such as the

sales journal, so that it would not appear as a separate item in the general ledger control account.

Receivables, other than trade accounts, such as debit balances in accounts payable, claims, advances, prepayments, and deposits, should be examined by reference to the transactions as recorded in the particular accounts and to such other supporting evidence as is available. The precise nature of these accounts should be determined for purposes of the scope of audit, the study of their collectibility, and their classification in the balance sheet. Confirmations should be obtained by direct communication with the debtors to the extent reasonable and practicable. These receivables as a class may not be significant in a balance sheet, but certain items may require more extensive procedures than are necessary for trade receivables continuously subject to routine accounting procedures.

The auditor should determine that drafts out for collection represent receivables recorded in the accounts, whether set up separately as drafts receivable or included in accounts receivable. In substantiating receivable balances owing from foreign debtors, the auditor cannot always employ the usual confirmation procedures, and therefore the existence of drafts aids his substantiation of these balances. The auditor should ascertain whether any drafts have been pledged against advances made by the banks with which the drafts were deposited for collection, or by other banks from which loans or advances on account of foreign shipments have been obtained.

Drafts in the hands of collection agents should be confirmed, and their status determined as of the balance sheet date. Drafts may be outstanding for one or more of the following reasons:

- They are not yet due.
- The drawee may have requested extension of time beyond the maturity date.
- Adjustments may be pending between foreign customers and the company's agent.
- The latest drafts deposited with the banks for collection before the close of the period under examination may not have been presented for acceptance because of the distance from this country to the port of destination.
- The drawee may have refused to accept the draft on presentation. In such instances, the sales should be reversed, and the goods should be included in the inventory.

Supporting Evidence.—Even though receivable balances are confirmed, it may be advisable for the auditor to compare billings,

shipping memoranda, or other data, with recorded transactions in accounts receivable, at least on a test basis. Such tests for the last week or month of the fiscal year should help to determine that a proper sales cut-off has been made. A desire to record sales in the period under review or thereafter may depend on various factors, such as officer bonus arrangements, sales quotas, royalties, or amount of taxable income. If merchandise is billed to customers and held for them, care must be exercised to exclude this merchandise from inventory and to determine that billing before delivery has been authorized by the customers.

Credit memoranda issued during the first month after the close of the fiscal year should be examined to determine that sales for the period ending at the balance sheet date were not inflated, and that allowances for discounts, returns, and freight have been provided in appropriate amounts.

If it is found that consigned goods are treated as sales and included in receivable balances, with a resulting anticipation of profits, the amount of the balances representing unsold goods should be adjusted to the basis of like items in the merchandise inventory. If the goods appear to be salable at a sufficient margin of profit, the related accrued charges, such as freight paid by the consignor, may be added to the inventory costs.

While checking charges to receivable accounts during examination of billings, the auditor should note any discounts allowed and ascertain that such discounts are in agreement with the concern's policies as shown by price lists or sales contracts.

Sales contracts with governmental agencies or selling agents and other agreements affecting receivables should be read. Various matters such as title to the accounts receivable, time of billings, method or time of payments, and special discounts, might well escape the attention of the auditor unless he reviews these documents. Fraud has been known to occur when installment sales contracts are hypothecated by a dealer. In one instance, each buyer was required to sign what were represented as original, duplicate, and triplicate copies of the contract. All these copies of the contract were actually typed as originals and later were pledged, one copy with each of three finance companies.

Confirmation of Receivable Balances.—Confirmation of receivables by direct communication with the debtors has been generally accepted auditing procedure for some years. The report of the Special Committee on Auditing Procedure (entitled "Extensions of

Auditing Procedure"), issued October 18, 1939 and approved by the American Institute of Accountants, states:

> That hereafter, wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as generally accepted auditing procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of confirming receivables in each engagement, and whether of all receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment.

Confirmations may be requested in respect of receivable balances as at the end of the fiscal period or as at a date reasonably close thereto, usually before the end of the period. Confirmation of receivable balances is as much a test of the efficacy of the internal control procedures as it is of the existence and dollar amount of the specific accounts confirmed. If the confirmation requests relate to balances as at a date other than that of the balance sheet, and the procedure has revealed no significant irregularities, the auditor is justified in assuming that substantially the same conditions exist as at the date of the balance sheet, provided his review of internal control procedures and transactions in the intervening period gives no indication to the contrary.

Replies from debtors to requests for confirmation should reveal whether the receivable balances confirmed are substantially correct. They also may reveal partial payments on notes receivable which may not have been endorsed thereon, as well as complete payments of fully paid notes which may have been returned to the maker. The existence of collateral, if any, also may be disclosed. When monthly or other periodic statements are not sent to debtors, confirmation requests frequently disclose a variety of differences and exceptions which require adjustment.

Selection of Accounts for Confirmation.—From his review of internal control procedures, the auditor should determine whether all or only part of the accounts should be confirmed and, if the latter, the basis for selecting the accounts to be confirmed. Accounts receivable selected for confirmation usually should include a representative portion of both the dollar amount and the number of accounts; they

may include all accounts with balances over a selected amount and a number of small accounts taken in numerical or alphabetical sequence groups, accounts with old unpaid items, and those written off during the period under review. The selection should exclude accounts when replies to requests for their confirmation cannot reasonably be expected, such as those with government agencies, foreign concerns, and chain stores.

An experienced auditor will usually confirm accounts which appear unusual, such as accounts with even dollar balances when the sales prices would not ordinarily produce even amounts. The confirmation of receivable accounts with credit balances should be considered, as there is always the possibility, especially when internal control procedures are weak, that the credit balance is not correct. Confirmation of an account receivable should not be omitted merely because payment or other credit has been recorded since the confirmation date. Sometimes the client will request that accounts not selected by the auditor be included among those to be confirmed, usually in the hope that the confirmation request may speed up collection; the auditor may properly accede to such a request.

Accounts receivable discounted or pledged, as well as notes receivable discounted or pledged, should be confirmed by those with whom discounted or pledged, so that any liability, contingent or otherwise, will be brought to the auditor's attention. Confirmation of these items by those with whom discounted or pledged does not mean that the auditor should not obtain a confirmation from the debtor concerned.

If the client does not wish statements or confirmation requests sent to certain debtors, the auditor should be satisfied that there is an adequate reason.

Confirmation Procedures.—After having decided upon the selection of accounts for confirmation, the auditor should observe the following rules in processing the statements, which are applicable for both the negative and the positive method of confirmation:

1. Names, addresses, and amounts shown on the statements selected should be compared by the auditor with the debtors' accounts. Thereafter, the auditor must maintain a continuing control over statements selected for confirmation until he has mailed them.
2. Debtors' accounts to which confirmation requests have been checked should be proved with the applicable control account. If all of the accounts are solicited, or all of a block of accounts

representing a controlled section of the receivables, proof should be obtained through adding machine tapes of individual receivable balances, prepared by the auditor or prepared by the client and checked or test-checked by the auditor. For a random selection of accounts the proof results from comparison of the accounts with a trial balance which in the aggregate is in agreement with the controlling account.

3. A return envelope, addressed to the auditor should be enclosed.
4. Letter requests or statements bearing the request should be mailed in envelopes, showing the return address of the auditor, or, if there is objection to use of this address, the return address may be to the client at a post office box controlled by the auditor. If the latter procedure is used, instructions should be left with the post office to forward mail to the auditor after the box is surrendered.
5. All requests should be mailed by the auditor, preferably in a post office and certainly not in the client's mail room.
6. Undelivered requests returned by the post office should be investigated, corrected addresses obtained and the requests remailed by the auditor.

The Negative Confirmation.—The negative method of confirmation is a request that the debtor communicate directly with the auditor if the statement of balance owing to the concern is in any way incorrect. Such request is conveyed by a sticker affixed to the statement, by a rubber stamp impression thereon, or by a special letter with or without a statement. The auditor encloses a business reply type envelope addressed to himself. This requires no postage and facilitates a reply. The auditor expects replies only when the debtor reports a difference; he may assume that no reply signifies the debtor's acceptance of the balance.

The negative method of confirmation is that most frequently used. It is recommended unless there are grounds to believe that this type of confirmation request will not receive consideration by the debtor. Depending on the circumstances of the engagement, the negative method of confirmation may well be supplemented by positive method confirmations, particularly of the larger balances.

It is important to impress upon the debtors the desirability or necessity of communicating directly with the auditors when discrepancies exist. If the auditor has reason to believe that the negative form of confirmation request will not receive consideration, he should

not feel that he has complied with generally accepted auditing procedures by sending out this form of confirmation request.

If the debtors are not circularized at the time statements are mailed or if no statements are to be sent to debtors, a letter form of request may be sent. With appropriate changes of language, the form of positive confirmation reproduced on page 158 may be employed.

If statements of account prepared by the client are sent to debtors, the auditor may inscribe the statements by means of a rubber stamp or affix a sticker reading somewhat as follows:

Please Check This Statement

In connection with a periodic examination by our auditors, we attach a statement of your account as shown by our books as at (date of statement).

Please check this statement and, *if it is not correct,* please report all differences directly to our auditors, (name and address of auditors), using the enclosed envelope.

If you do not report any exceptions, it will be assumed that the statement is correct.

This request is for information and not for payment. We thank you for your cooperation.

Very truly yours,
(Client)

For installment receivables, a slightly different form is suggested, as follows:

Important

Date (Date of statement) ....

This request for information is made in connection with the periodic audit of our accounts.

The attached statement shows the amounts *due us at the above date* on your account as described therein, according to our records.

Please examine the statement carefully and if it is *incorrect,* communicate directly with our auditors, (name and address of auditors).

If you do not report any exception, it will be assumed by our auditors that the statement is correct.

Very truly yours,
(Client)

The Positive Confirmation.—The positive (affirmative) method of confirmation is a request that the debtor send directly to the auditor an affirmation that the amounts and other details shown on the statement or letter submitted for confirmation are correct. The

request is conveyed by a letter, or on the statement by means of a rubber stamp impression or an affixed sticker. To facilitate replies, the auditor encloses a stamped or a business reply envelope addressed to himself.

Because the form of the request specifically asks for a reply, the auditor may not assume, as in the case of the negative form of confirmation, that failure to reply to his request indicates that the debtor agrees with the reported balance. He should make second, and if necessary, third requests by registered mail to obtain proof of delivery. If he fails to receive positive confirmation of a substantial number of accounts or material dollar amount of receivables, the auditor should employ supplementary auditing procedures, as recommended later.

The positive method of confirmation is not generally recommended, except when there are indications that there may be disputes, inaccuracies, or irregularities in the accounts, or when the receivables are the major asset of a business or arise from sales to a few large customers. Thus, the receivables of stock brokerage houses are customarily confirmed by the positive method. It should be remembered that a favorable reply to a positive confirmation request is not always conclusive evidence that the unpaid receivable balance is correctly stated. Later examination of supporting evidence may disclose that the account was misstated at the date of the confirmation request.

Unless the replies to positive confirmation requests are satisfactorily numerous, the auditor is in no better position to judge the reliability of the receivable balances after he has sent out the confirmation requests than he was before. Experience has shown that the percentage of replies received varies considerably with the type of customer with whom the organization deals, and the auditor must exercise his judgment in deciding whether the nature and extent of the response are satisfactory.

Responsibility for genuineness or authenticity of signatures on replies to positive confirmation requests cannot be assumed by the auditor. Not only will replies be received from debtor corporations signed by officers unknown to the auditor as such, but also from debtor individuals signed by persons as agents, trustees, or guardians whose authority to so sign is unknown to the auditor. The practical difficulties involved in attempting to determine the genuineness or authenticity of signatures make it impractical and unreasonable for the auditor to attempt to do so. However, the client should be urged to complete the confirmation procedure by reviewing the signatures for genuineness and authenticity. Attention is also directed

to Rule X-17A-5 of the Securities and Exchange Commission and identical Rule 532 of the Board of Governors of the New York Stock Exchange, both relating to the scope of the auditor's examination of replies to requests for confirmation of receivable balances of stock brokerage firms and certain other clients. When the signature on a reply does not agree with the name of the account, the auditor should ascertain that the client has written evidence of the authority of the person signing the reply to so act. When the client cannot produce such written evidence, the auditor should consider such accounts unconfirmed and should mail second requests appropriately worded to obtain properly signed replies.

For the positive type of request, experience has shown that a form which requires a minimum of effort on the part of the recipient will produce the greatest percentage of replies. The letter form of positive request is designed for use when no statements of account are to be mailed to debtors or when the requests are sent after the statements have been mailed by the client. On receipt the debtor has only to sign his name in the space provided at the bottom of the letter, if the amount shown is in agreement with his records, and mail the letter in the return envelope which has been provided. This letter form is illustrated as follows:

(Date)

(Name and address of debtor)

Dear Sirs:

In accordance with the request of our auditors, (name and address of auditors), we ask that you kindly confirm to them your indebtedness to us at (date) which, according to our records, amounted to (amount).

If the amount shown is in agreement with your records please so indicate by signing at the space provided below and return this letter directly to our auditors in the enclosed envelope. Your prompt compliance will facilitate the examination of our accounts.

If the amount shown is not in agreement with your records, please inform our auditors directly what amount is shown by your records and, if possible, send them full particulars regarding the difference.

Very truly yours,
(Client)

The above stated amount is correct as at (date).

(Debtor of client)

....

If statements of account prepared by the client are to be sent to debtors and used as a basis for positive confirmation request, one of the following procedures may be appropriate:

(a) The statement may be sent out in duplicate with a request that the debtor acknowledge its correctness by returning the duplicate directly to the auditor, duly signed. A variation is the form of monthly statement in which the balance owing and the name of the debtor appear in two places, one of which is separated from the main body of the statement by perforations. The coupon may be torn off, signed by the debtor and returned directly to the auditor.

(b) The auditor may imprint each statement with a rubber stamp, or affix a sticker conveying a confirmation request similar to that shown in the following illustration:

DETACH HERE

IMPORTANT

In connection with the periodic examination of our records by our auditors, (name and address of auditors), we attach a statement of your account as shown by our books as at (date of statement).

PLEASE EXAMINE THIS STATEMENT

If *correct,* kindly sign below and return this slip direct to our auditors.

If *not correct,* please give details of differences direct to our auditors, (name of auditors) using the enclosed stamped envelope.

Very truly yours,
(Client)

(Debtor of client)
Correct (sign here) ....

A form of positive type confirmation request which has been found satisfactory in substantiating ledger balances and security positions of customers of stock brokers follows:

Date..............................

Our auditors, (name and address of auditors), are now making their regular examination of our accounts as at the close of business on the above date, and in connection therewith they desire to have you verify the correctness of the enclosed statement of your account with respect to the security position and money balances at that date, as summarized below. Your prompt compliance with this request by signing the certificate at the bottom of this form will be appreciated.

A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client)
....

(Customer)
To..

(Address)
....

Debit Balance.......................... Credit Balance...............

SECURITY POSITIONS	
Quantity	Description
	Long :—
	Short :—

The statement of my account, as summarized above, is correct.

(Signed) ....
(Personal or authorized signature required)

DIFFERENCES, IF ANY, SHOULD BE TAKEN UP DIRECTLY WITH THE AUDITORS

Exceptions to Confirmation Requests.—Exceptions reported in replies to confirmation requests should ordinarily be investigated by the auditor. The investigation of these exceptions or alleged exceptions by the auditor may consume more time than their significance warrants, and if the exceptions are not material in amount nor indicative of serious weakness, they properly may be turned over for investigation to a responsible individual of the client's organization whose regular work does not involve the handling of, or accounting for, cash or receivables. The findings of this individual should be reviewed by the auditor and he should obtain copies of any resulting important correspondence with debtors for his work paper file. Many exceptions reported will ordinarily prove to be in effect not discrepancies but merely payments in transit. Other exceptions reported, probably small in individual amounts, will result from disputes over allowances, discounts, shipping charges, or returned merchandise.

If the exceptions reported are significant in amount or numerous, the auditor's investigation may reveal serious weaknesses in internal control procedures, such as delay in recording debtors' remittances, or a breakdown in billing procedures or in adjusting debtors' claims. Then the auditor will have to decide what further auditing procedures will be necessary in order that he may satisfy himself as to the substantial accuracy of the amounts at which the receivable balances are stated as at the balance sheet date.

Procedures in Lieu of Confirmation.—When replies to confirmation requests cannot reasonably be expected, as from government agencies, foreign concerns, and chain stores, or when the number and character of replies to positive confirmation requests are not satisfactory, the auditor should attempt to satisfy himself by other means as to the substantial accuracy of the receivable balances. The inability to confirm certain receivables, if substantial in amount, should be disclosed in the scope paragraph of the auditor's short form of report, in accordance with Bulletin No. 12 issued in October, 1942, by the Committee on Auditing Procedure, but no exceptions need be taken in the opinion paragraph of the report provided the receivable balances at the balance sheet date are substantiated satisfactorily by other methods.

These other methods include the examination of cash receipts and other records of subsequent payments, bank advices, shipping records, sales contracts, correspondence, and other documentary evidence. The examination of remittances and remittance advices as they are received appears to be the best alternative to confirmation, but if this procedure is not feasible, the examination of remittance advices and comparison of them with recorded cash receipts should be a satisfactory method. Care should be taken to see that, insofar as possible, particularly when bank deposits include both cash and checks, the constituent items of deposits and recorded cash receipts are identical.

Collectibility.—The collectibility of receivable balances should be reviewed to ascertain the required amounts of allowances to cover estimated losses which have occurred, or are expected to occur, rebates which may have to be made, or cash or other discounts which can be expected to be taken by debtors in the settlement of their accounts; or if such allowances have been set up, to determine that the amounts are neither insufficient nor excessive. Receivable balances should be carried at their net estimated realizable amount. The auditor must satisfy himself not only that the gross amount is fairly stated, but also that proper reductions have been made by allowance accounts.

The auditor should examine transactions affecting receivables subsequent to the balance sheet date, such as cash receipts, discounts allowed, rebates, returns, and write-offs, as these transactions or their absence may reveal abnormal conditions as to the collectibility of the receivable balances at the balance sheet date. What actually occurs after the close of the fiscal period is the best proof of whether the receivable balances are actually what they purport to be.

Notes and acceptances receivable, past due or not, may themselves be indicative of doubtful collectibility when it is not the trade custom to take notes; when they have been taken for overdue accounts receivable; or when they represent renewals of matured notes or acceptances. If it is usual to obtain notes or acceptances from debtors of high credit standing, the collectibility of the notes should be considered in the same manner as that of other receivables. The collectibility of notes against which collateral has been pledged may depend not on the debtor's credit standing, but on the value of the collateral.

Receivable balances, especially those with items past due, should be reviewed with the credit manager to obtain information on which to base an opinion as to the possibilities of collection. Correspondence files with collection agents or debtors should also be reviewed, especially if explanations by the credit manager are not satisfactory. Information required by the auditor for review with the credit manager can be obtained from aged trial balances or by scanning individual ledger accounts for items which appear to be overdue. If the volume of accounts is large and transactions are numerous it is not practicable for the auditor to scan the individual accounts except on a test basis. At least a partial aging of accounts is required as a supplement to test-scanning.

If it is not the client's practice to age accounts receivable periodically, he may be requested to prepare an aged trial balance for purposes of the audit. When there are many accounts, a representative portion of them may be aged and the results regarded as typical of all the accounts. Aged trial balances prepared by the client should be test-checked by the auditor to the ledger detail.

Whether all or only a portion of the accounts are aged, the results obtained, to be of value, must be reviewed with due consideration of the client's policies and its past experience with respect to credit losses.

The following suggestions will be found useful for the auditor's study of aged trial balance data or review of individual accounts receivable:

1. Have the terms of credit been ignored habitually? If so, the debtors' credit may be perfectly good, but the accounts should have special attention of the credit manager.
2. If payments are being made on account, are the balances increasing or decreasing? If they are increasing, it may be evidence that the debtors are approaching the time when all

payments will stop. Accounts of this sort deserve more attention than they generally receive. Salesmen relinquish accounts reluctantly, and they are not the best authorities on the ability of debtors to pay.

3. An old item in a running account or a bill partly paid, followed by others fully paid, may indicate an amount in dispute on which an allowance may have to be made. Also, it is possible that the item is open because the amount received in payment has been misappropriated. If the amount is substantial, or if the explanation is not satisfactory, the auditor should request that correspondence or other data be submitted to him in support of the explanations offered.
4. If credit has been stopped and no recent collections appear, the accounts may have been placed with attorneys for collection. If so, it is well to ask for the correspondence. If accounts are neglected, the debtors will not pay. So long as their money lasts, or so long as they desire to preserve their credit, debtors pay those who press them hardest.
5. If debtors who have formerly paid cash begin to give notes, the auditor should ascertain whether sound reasons have been offered and that the change has been approved by someone in authority.
6. Many concerns assign old outstanding accounts to agencies for collection on a percentage-of-recovery basis. If this is the practice, the auditor may obtain information, by correspondence with the agency, of amounts collected, of accounts found worthless, and of the face amount and estimated realizable amount of those still held for collection.
7. The auditor should ascertain whether receivables from employees are permitted to run past payday without some collection, and should particularly inquire into balances against persons who have left the client's employ.

Receivables from affiliates, directors, officers, and employees should be reviewed to determine that they are actually what they purport to be. If they represent advances or loans, they should be segregated and described as such. These receivable accounts should be scrutinized even though they appear to have been settled before the balance sheet date. An account may have been credited at the end of the fiscal period on receipt of an officer's check, when, in fact, the officer did not have sufficient funds in the bank to cover the check.

He may subsequently cover his personal check by depositing one from the company issued to him after the balance sheet date. If there is any doubt as to the affiliate's or individual's resources, the auditor should not only look at transactions affecting these accounts after the end of the fiscal period to see if the advance or loan is again made, but usually he should endeavor to learn the source from which the money for the repayment was obtained. Past practice, when amounts have been loaned over a long period of time, often throws light on the good faith of the apparent liquidation of a loan. It should not be felt that the disclosure of receivables from affiliates, directors, officers, and employees reflects on the integrity of these debtors. If the client objects to their disclosure, the auditor may question whether the nature of these receivables is fully understood and further investigation may be necessary.

Time of Examination.—Whether the examination of receivable balances can be made as at a date prior to the date of the balance sheet will depend largely on the completeness and effectiveness of internal control procedures. Seasonal or other factors affecting the nature, number, and size of receivable balances as between the two dates also should be considered. Such advance examination of receivables should ordinarily be within, say, 60 days of the balance sheet date, in order to minimize the volume of intervening transactions which must be reviewed and to retain some measure of correlation between the accounts examined and the accounts at the balance sheet date. The examination of receivable balances as at a date other than that of the balance sheet, when deemed advisable, should prove advantageous not only to the auditor but also to the client, who thereby may reduce the volume of clerical work otherwise necessary immediately after the close of the fiscal period. In addition, more time is available both for the auditor and for the client to investigate any differences disclosed by the examination.

Many concerns having a large volume of accounts have adopted a "cycle billing plan" to spread the incidence of the work of posting, collecting, billing, and reviewing of the accounts. Under this plan accounts receivable at any date are a composite of charges billed up to intervening prior dates and charges accumulated for billing at subsequent dates of the monthly cycle. Advance examination of such receivables affords the auditor more time for making selections of accounts to be confirmed and for review of probable collectibility.

In businesses such as utilities and department stores where the volume of operations is large and the receivables are homogeneous

regardless of date, receivables can be examined fairly well in advance of the balance sheet date. That is to say, confirmation requests can be mailed; controls, trial balances, and aging schedules can be checked; and collectibility of the accounts can be reviewed as of the advanced date. The results of this interim examination, together with a general review of intervening transactions, should afford a reasonable basis for an auditor's findings and opinion effective as of the balance sheet date. The same result often can be realized effectively in respect of receivables of other large-volume businesses when the examination is made not more than one or two months prior to the fiscal closing date.

Probably the more common procedure in the examination of accounts receivable is to mail confirmation requests and reconcile subsidiary ledgers to general ledger control accounts at the advanced date and to review collectibility of the accounts and make appropriate test checks as at the balance sheet date.

Coordination of Examination with That of Related Accounts.—Other items appearing on the balance sheet or statement of income often substantiated at least in part concurrently with the examination of receivable balances include:

Notes and accounts receivable discounted
Contingent liabilities
Sales
Discounts allowed
Interest and dividend income
Pay roll deductions

Conversely, the auditor's examination of the above items may well disclose certain receivables of which he might not otherwise be aware.

It should be the auditor's practice to consider the reasonableness of receivable balances in the light of the ratio of these balances to related items in the financial statements. If a client's statements have been examined for several years, the comparison of ratios developed in the current engagement with those of prior years may quickly put the auditor on notice that all is not as it should be. In addition to determining the ratio of the trade receivable balances outstanding as at the balance sheet date to net sales on credit for the period under review, the auditor may also determine the number of weeks' or months' net sales on credit represented by the balance of trade accounts receivable at the balance sheet date.

Written Representations by Client.—On some occasions the auditor may desire to obtain written representations from the client as to accounts receivable, similar in nature to those for inventories and liabilities. The major items which such written representations may cover are listed in Statement on Auditing Procedure No. 4, issued in March, 1941 by the Committee on Auditing Procedure.

STATEMENT PRESENTATION

Statement presentation of receivables involves matters of description and classification. Problems arise when amounts are significant, either individually as a class of receivables or relatively in respect of other classes of receivables or other assets of the balance sheet. The minimum requirement is adequate and informative disclosure of the nature of the receivables and bases of valuation.

Description.—If only the term "accounts receivable" appears on the balance sheet among the current assets, the reader is justified in assuming that the amount so described is collectible within the period usual to the particular trade or industry from the trade debtors (customers) of the company.

Whenever the amounts are significant, or the rule of informative disclosure is applicable, there should be separate description and identification of other than trade receivables, such as:

- Amounts receivable from affiliated and subsidiary companies
- Receivables arising from sales to employees
- Amounts receivable from officers, directors, and stockholders
- Amounts receivable from transactions outside the ordinary course of the business
- Deposits, advances, interest, amounts recoverable for returned purchases and claims.

Separate description and identification may be appropriate for various kinds of trade receivables, such as notes and acceptances, installment accounts, accounts pledged as collateral, accounts past due, and notes discounted.

When receivables from other than trade debtors are not sufficiently significant to be stated separately they are usually grouped for the balance sheet in one figure described as Accounts Receivable Other, or under some similar caption.

Receivables from customers may be captioned in accordance with terminology customary in a particular trade or business; thus,

premiums receivable may be used by insurance companies, rentals receivable by real estate owners, or commissions receivable by commission houses. Care should be used in describing receivables as "due from customers" because at the balance sheet date open balances may be due, not yet due, or past due. If it is desirable to segregate unsecured notes from those against which collateral is held, the careless usage of the word "secured" should be avoided. Its use may be understood by many to mean that the collateral within a reasonable time can be converted into cash sufficient to pay off the note. This may not be true. A so-called "secured" note may be worth no more than the realizable value of its collateral.

Classification and Segregation.—Receivables arising from ordinary transactions of the business, which reasonably are expected to be collected during the normal operating cycle, are classified on the balance sheet as current assets, usually immediately after cash or marketable securities, if any. Thus installment or deferred receivables, if they conform to normal trade practices and terms within the type of business, may be so shown, even if maturing beyond twelve months. If the normal operating cycle of the business extends beyond a period of one year because of long credit terms, such as for installment receivables, it is proper to classify the receivables as current assets, but if inventories long in process are the sole reason for extension of the normal operating cycle beyond a period of one year, such classification of receivables maturing more than one year from the date of the balance sheet is not proper. Determination of whether receivables arising from transactions outside the ordinary course of business, such as from the sale of fixed assets or advances to affiliates, officers, or employees, should be classified as current depends not only on the expected collectibility within the normal operating cycle of business, but also on whether the proceeds may be expected to be available for additional working capital; this treatment is in accordance with the principle that current assets should include only those receivables which involve a circulation of capital within the current asset group.

Accounting Research Bulletin No. 30, issued in August, 1947, sets forth certain principles governing the classification of assets and liabilities as current or noncurrent. The Securities and Exchange Commission also has a rule (Rule 3-13) in Regulation S-X relating to such classification. Text of that rule is as follows:

> Items classed as current assets shall be generally realizable within one year. However, generally recognized trade practices may be fol-

lowed with respect to items such as instalment receivables or inventories long in process, provided an appropriate explanation of the circumstances is made and, if practicable, an estimate is given of the amount not realizable within one year.

The accounting research bulletin has not entirely discarded the one-year rule, formerly emphasized in the classification of receivables as current or noncurrent, but regards it as only one of the factors for determination of classification.

For statements prepared in accordance with Regulation S-X of the Securities and Exchange Commission, notes receivable and accounts receivable are shown separately, and accounts receivable are segregated as to trade accounts receivable and other accounts receivable. For general-purpose statements such segregations may not always be essential.

Notes and acceptances receivable arising in the ordinary course of business may be combined in one amount. They frequently are shown in combination with accounts receivable under one common designation, i.e., notes and accounts receivable. Significant amounts of trade installment notes or accounts receivable should be stated separately.

In considering the statement presentation of notes receivable, the custom of the business under review should be kept in mind, for in some, notes are given by concerns of the highest standing, whereas in others, notes may be considered a sign of weakness. Demand notes are not necessarily current because of being payable on demand, and care should be taken in classifying them, especially when the related interest, if any, is not being collected currently. In addition, other notes, even though not due, may not be current if the debtor has had financial reverses making prompt payment of the note unlikely. Interest accrued on notes receivable may be included with the face amount of the notes provided the caption so indicates.

It is customary for agricultural implement manufacturers to take notes for a substantial part of sales, many of which notes are not paid during years of crop failures. So far as realization is concerned, they are considered by management to be almost as collectible ultimately as unmatured notes. In such circumstances, when considering notes receivable for classification in the balance sheet as a current asset, the auditor may conclude that it is unnecessary to separate overdue and unmatured notes, provided a sufficient allowance has been made for any probable loss. Except as sanctioned by trade custom or practice, any significant amount of dishonored notes

receivable should be indicated in the balance sheet even though they are deemed to be collectible after default.

Many contracts include a clause requiring the vendee to make payments as the work progresses, permitting him to retain a percentage of the total amount until the contract is completed and the product accepted. The portion of the contract price representing the retained percentage may not be readily collectible, even during the normal operating cycle of the business. The circumstances of each such account of material amount should be investigated to determine whether the retained percentages may be included as current assets.

Receivables from subsidiaries or affiliates, if significant in amount, should be stated separately. Payment of these accounts before the balance sheet is released does not justify deviation from this practice, for the reader of the statements should be informed of these amounts as at the balance sheet date. Whether receivables from subsidiaries and affiliates are current or noncurrent depends largely on the expectation of realizing them in cash. Even though arising from ordinary business transactions and even though the debtor company is financially sound, in effect they may be long-term advances.

Receivables from employees arising in the ordinary course of business are sometimes stated separately on the balance sheet, although opinions differ as to the necessity for this segregation. It is contended that employees are customers, even though they are granted special discounts, and that collections on their accounts often can be made more readily than on the accounts of other customers. Unless such receivables from employees represent a substantial portion of the total receivables from trade debtors, or unless special circumstances require disclosure, there seems to be little reason for segregating them.

Receivables from directors, officers, and principal stockholders, if significant in amount, whether arising in the ordinary course of business or whether collected subsequent to the balance sheet date, should be stated separately in the balance sheet. The distinction between these receivables and trade receivables rests on whether the relations between debtor and creditor are such that affiliation or self-interest will influence prompt and full collection.

Receivables from foreign debtors, when significant in amount, whether represented by drafts receivable or not, should be segregated on the balance sheet. The time required for collection of these receivables ordinarily will be greater than that for similar items of domestic origin.

Credit balances in accounts receivable should be classified as liabilities unless they can properly be offset against debit balances. Often they represent advances to be applied against unbilled orders and are in the nature of accounts payable. If significant in amount, they should appear among the liabilities, grouped separately as customers' credits. Conversely, debit balances in accounts payable that are not direct offsets to credit balances should be segregated for classification in the balance sheet among accounts receivable.

Receivables arising from transactions other than sales in the ordinary course of business may include advances to salesmen and others, loans to officers, claims against railroads, creditors, or some branch of the government, and prepayments on purchase contracts. Not infrequently they include considerable amounts rarely settled in cash and representing charges to vendors for goods returned to them. Often deferred charges to operations, such as rents paid in advance and similar items, are included under the caption "Accounts Receivable" although in no sense of the word is this proper. Items representing receivables other than trade accounts should be shown individually or grouped according to their relative importance under appropriate descriptive captions in the balance sheet.

Receivables arising from subscriptions to capital stock should be stated separately on a balance sheet as by their nature they are dissimilar from other types of receivables. Some objections have been raised to showing subscriptions receivable as an asset, but, if the debtors are financially responsible and the amounts are apparently collectible, they represent a realizable asset. If, however, they are overdue and doubtful of collection; if there is no intention of calling for unpaid subscriptions; if subscriptions are payable only out of dividends earned on the stock; or if there is any other contingency with respect to their payment, they may well be treated as a deduction from capital stock subscribed in the capital section of the balance sheet. Such receivables, even though collection may be expected in cash at an early date, should not be classified as current assets unless the proceeds therefrom are to be added to working capital.

Cash deposits put up as security when making bids for public work, to assure the faithful performance of contracts, as security for costs in an appeal to a higher court, for goods ordered in advance, or with public utility companies properly may be included in current assets if they are known to be repayable within the normal operating cycle of the business, and involve a circulation of capital within the current asset group. Deposits made to secure options for the purchase of real estate or plant are not current assets, as generally the

deposit becomes a part of the cost of purchase of a fixed asset or is forfeited if the transaction is not consummated. A cash deposit required by terms of a lease may be returnable, but the time of realization may be uncertain and often the company cannot depend upon the deposit as a fund available for other purposes than the special one for which it is made. The landlord holding a cash deposit as security under a lease may require the same or a larger amount upon renewal, or if there is no renewal, the landlord may hold the deposit for several years, pending the settlement of a claim for damages to the premises.

Receivables Pledged, Sold or Discounted.—If receivables are pledged against loans, the amount pledged should be indicated in the description of the receivables and also in the description of the loan liability.

If receivables are sold under a guaranty of repurchase by the seller, any portion of the collections withheld by the buyer should be shown as a receivable by the seller. The contingent liability associated with the guaranty of repurchase should be indicated in the balance sheet.

The total amount of receivables discounted preferably should be shown among the assets of the balance sheet with a contra liability, which thereby discloses the contingent liability related to the items discounted. Other methods of presentation include indicating the contingent liability in a footnote to the balance sheet, or deducting the discounted items from the aggregate receivables leaving a net amount representing the receivables not under discount.

When discounted items have been paid by the makers after the balance sheet date, but before the financial statements have been released, it sometimes has been urged that there is no necessity to indicate the existence of discounted receivables as of the balance sheet date. The authors believe, however, that the balance sheet should indicate the condition as of its date, inasmuch as the information regarding discounted receivables may be of significance to readers of the balance sheet. There is no objection to including a notation on the balance sheet that the discounted items were paid at maturity.

Sometimes loans are obtained by discounting bank acceptances which have been issued against pledge of customers' notes or acceptances, such transactions generally developing from sales made in foreign countries. The company's foreign representative obtains a bank acceptance and deposits, as collateral, the notes received from customers. The company in turn discounts the acceptance. The amount of the collateral will generally exceed the face value of the

acceptances. Collection of the customers' paper usually occurs before the bank acceptance becomes due. Opinions differ as to whether the amount of the unmatured bank acceptances discounted should be shown as a liability or as a deduction from the assets. The following summary illustrates a method of stating the transaction on the asset side of the balance sheet and sets forth the facts:

Customers' notes and acceptances assigned to bank:	
Unmatured	$110,000.00
Already collected and proceeds held	100,000.00
	210,000.00
Less, Bank acceptances issued against above and discounted, but not yet due	200,000.00
Equity	$ 10,000.00

Allowances Deducted from Receivables.—Allowance for doubtful receivables should be deducted from the related asset, the asset being shown on the balance sheet either gross less the allowance, or net, preferably with the amount of the allowance indicated in the caption heading. If the asset is shown net, the fact that an allowance has been deducted should be indicated even if the amount of the allowance is not disclosed. It is not considered necessary to disclose the amounts of the individual allowances if a combined allowance for doubtful notes and accounts receivable is deducted from the sum of the related asset amounts. Other allowances, such as those for cash discounts, collection costs, or decrease of profit because of expected returns of merchandise, should be shown similarly, and they may be combined in one amount with the allowance for doubtful receivables, provided this is indicated in the caption. Carrying or interest charges on installment accounts receivable that have been deferred as unearned at the balance sheet date should be classified in the balance sheet as a deduction from the receivables, either directly from the installment accounts or from the sum of the receivables as part of the total allowances.

CHAPTER 11

INVENTORIES

The eight years which have elapsed since the sixth edition of this book appeared in 1940 have witnessed some interesting developments in the problems of inventory determination. The profession as a whole has had time to digest the rule adopted in 1939 that where practicable and reasonable the auditor should observe the taking of inventories; previously there was some diversity of opinion among the profession as to this procedure. The war years brought forth some difficult problems and challenged the accountant's ingenuity to find the best reasonable substitute where war production could not be interrupted for physical inventory taking.

The profession has reached substantial agreement upon some important inventory valuation problems. In 1947 the Committee on Accounting Procedure of the American Institute of Accountants issued two bulletins, "Inventory Pricing" and "Inventory Reserves." The first bulletin is of interest in the application of the lower of cost or market rule. Accountants have long recognized that, when an inventory is consistently carried at cost and where operations are at a profitable level, even if replacement costs are lower than cost, no write-down may be necessary; this concept is now placed within the structure of the lower of cost or market rule. The first bulletin also gives general recognition to the necessity for providing for losses on purchase commitments, measured in the same way as inventory losses. The second bulletin treats primarily with reserves for general contingencies relating to inventories or for reducing inventories to other than a generally accepted basis. In the opinion of the committee no charges or credits relating to such reserves should enter into the determination of net income.

The inflation of our price structure has produced problems in accounting for inventories that have not been answered by the accountant, and perhaps cannot be answered, to the entire satisfaction of management, labor, investors, and the public. The businessman insists that profits realized from carrying inventories in time of rising prices may be transitory and offset by losses when prices fall. He proposes the creation of reserves to eliminate such profits from income and to provide for possible future losses. While generally accepted accounting principles permit the creation, in effect, of such reserves out of income (through the adoption of the last-in, first-out method of applying cost, the base stock method, or similar methods) they do not permit reserves with an indefinite basis to be charged to income for the same purpose, probably because of the public accountant's fear that the unrestricted adoption of such reserves would reduce the financial statements to arbitrary creatures of management.

The public accountant's position can be said to be not entirely logical, but it is based on very practical considerations.

The principles of inventory valuation have long been subject to a tug of war between two groups, the first advocating the balance sheet, and the second, the income statement, points of view. Historically, the former have proposed conservative balance sheet methods and have insisted on the application of the market test to cost; the latter have favored cost in the balance sheet without regard to market, chiefly to maintain charges to income at cost. More recently, the proponents of the income statement point of view have become alarmed at the effect on future income which price fluctuations may have and insist that current revenues be matched with current costs, resulting under present conditions in conservative inventory valuations such as under Lifo, which may be very substantially below current cost or market. An ultimate solution, satisfactory to both schools of thought, may well be the valuation of inventories in the current section of the balance sheet at the lower of current cost or market, and the carrying of reserves outside of the current section to reflect the excess of such inventory valuation over a basis such as Lifo.

While accounting thought on matters of principle has crystallized greatly in recent years, the determination of inventories will always in practice call for a considerable amount of judgment and good plain common sense. Theoretical considerations should never lead the accountant away from his usual primary balance sheet objective —that an inventory be stated not in excess of its net realizable value in the ordinary course of business.

ACCOUNTING PRINCIPLES

Components of Inventories.—Inventories usually include only items of tangible personal property which, in view of their nature, quantities, and condition, will be sold or will enter into the production of items to be sold in the ordinary course of business within a reasonable period of time. Inventories generally consist of finished stock (goods awaiting sale), work in process (goods currently in the course of production), and raw materials and supplies (goods to be consumed directly or indirectly in the course of production).

Nature, Quantities, and Condition.—While the inventory of a contractor and builder contains real estate awaiting sale, the inventory of the ordinary manufacturing enterprise obviously excludes any

such item. The question of what to include and what to exclude from inventories by reason of its nature usually presents no great difficulty to the public accountant. Manufacturing and maintenance supplies are properly includible, as are spare parts for machinery, although some accountants prefer to classify the latter with plant, particularly if the investment is large and the rate of turnover small. In the manufacturing business, the dividing line is very fine between inventories and short-lived plant equipment; although expenditures for tooling represent productive facilities, they may be consumed or become obsolete in a short time and they are closely associated with the product. The authors believe it proper to include assets of this nature in inventories if they are to be used in production within a reasonable period of time, which is defined below. Supplies which are ultimately chargeable to selling, general, and administrative expenses, if inventoried at all, preferably are classified as prepaid expenses.

Public utility companies usually are engaged in continuous programs of construction and maintenance and the same inventory items are frequently used for both purposes. Thus, while the classification of the construction portion as a current inventory item is a violation of the principle set forth above, segregation is usually not feasible and probably not essential for the average public utility, and the only practical solution is disclosure. Certain manufacturing enterprises have the same problem where products of the same nature are both sold and leased.

Inventories should consist substantially of quantities which will be sold or consumed in a reasonable period of time. Excess inventories are commonly the result of poor purchasing or changes in demand, and should be considered in conjunction with purchase commitments. Unless the excess inventory can surely be disposed of over a period of time, the problem becomes one primarily of valuation and may be very difficult; transfer of excess inventory to noncurrent assets at estimated sales value may be required.

Inclusion of an item in the inventory implies that it is expected to be salable. If its condition is such that there is no real demand for it, or if it is subject to obsolescence or spoilage, the solution is again revaluation at a reduced or nominal amount which can be expected to be realized.

Reasonable Period of Time.—A reasonable period of time ordinarily means one year or the normal inventory turnover period (the average period of time between the acquisition of inventories and their sale in the ordinary course of business), whichever is

greater. Thus the accumulation of a substantial inventory of items in quantities greater than can be sold within one year, where the inventory turnover period is less than one year, ordinarily calls for segregation of a portion as a noncurrent asset. But it must be borne in mind that almost every inventory contains some items or groups of items which have a turnover period differing from the inventory as a whole and, although they move more slowly than the rest, are not impaired in value and may be considered to be a current asset. Spare parts or special sizes are frequently made up in quantities sufficient for several years' sales, in order to achieve manufacturing economies; sometimes these inventories are the object of special valuation formulae based on the principle that only a portion will be sold at the full selling price and that the balance will be worthless.

Thus, in considering an inventory where the indications are that a portion will not be sold within a reasonable period of time, the accountant should determine whether the slow portion seems worth the amount at which it is stated; mere segregation of slow-moving inventory is not always adequate treatment.

Considerations of Title.—Like other assets on the balance sheet, legal title to inventories is usually the line of demarcation in determining whether or not specific items are includible. If the auditor is in doubt regarding any transaction of substantial consequence as to whether title at the date of the balance sheet is vested in his client, counsel should be consulted. It does not follow, however, that this rule must be followed blindly; it has its limitations as a satisfactory basis for settling doubtful cases and may often be disregarded in determining the balance sheet treatment of the items in question. Customarily, purchases in transit are included in inventory and sales in transit are excluded, regardless of the status of title, although purchases in transit shipped f.o.b. the purchaser's plant may properly be excluded. There have been numerous cases in which there has been intent to deceive creditors by omitting the cost of merchandise from the assets and the related debt from the liabilities on the grounds that title had not passed and that it would have been improper to account for the stock until title passed. For accounting purposes, the intent of the parties generally should govern, provided that the treatment in handling inventory transactions is consistent.

The following are examples of items that should be included in inventories, following the rule of title:

Goods in transit (shipped f.o.b. the vendor's shipping point on or prior to the inventory date) should be in the purchaser's inventory.

Consignments out (in the hands of the consignee) should be in the consignor's inventory.

Bailments (in the hands of the bailee) should be in the bailor's inventory.

Goods out on approval (in the hands of the prospective customer) should be in the seller's inventory.

Protective title to c.o.d. and certain types of export shipments remains with the seller until payment is made; the seller of goods on the installment basis may also retain protective title. Shipments under these arrangements may or may not be accounted for as sales by the seller before payment is made and title passes. The important consideration is not one of title but whether the receivable is good.

Progress Billings and Advances.—The usual basis for crediting inventories is the shipment of goods and the passage of title to a customer. However, it is frequently customary under long-term contracts to bill the customer as the work progresses, under contract provisions which may call for the right of inspection or for architect's certificates; the contractor usually has performed all that he has to perform, except possibly to see that the finished product shall be satisfactory, to be finally entitled to the progress payment. Under these and similar circumstances it is customary and accepted practice to record sales and cost of sales on a progress or percentage of completion basis.

Advance payments by customers or by factors against inventories, sometimes involving a lien thereupon, usually represent a loan or a financing arrangement and should not be credited to inventories but treated as liabilities.

Valuation of Inventories.

Lower of Cost or Market, the General Rule.—The basic reason for carrying an inventory in the accounts and on the balance sheet is not only to reflect properly the existence of an asset but also to permit the results of operations of the enterprise to be presented fairly from period to period. As it is customary only to inventory items which will be useful in subsequent operations, charging off those which have entirely lost their usefulness, so also has it become the practice to carry forward the cost of useful items only to the extent of useful value, and hence the origin of the lower of cost or market rule.

Valuation of inventories at the lower of cost or market has long been the prevailing practice. Some companies in lines of business which were not subject to severe price fluctuations in their finished product and which consistently operated at a profit have valued their inventories at cost without regard to market, but even these frequently wrote down portions of their inventories for reasons of obsolescence, deterioration, or obvious unsalability. One of the objections which these companies had to the lower of cost or market rule was that market was defined as the lower of (1) replacement or reproduction cost and (2) net selling prices. Thus, any decline in the cost of replacing or reproducing an inventory, regardless of whether such decline would be reflected in the price of the finished product, was required to be eliminated from the inventory. Accounting Research Bulletin No. 29, issued in July, 1947, revised the definition of market in this respect and approved certain changes in the application of market. The new definition of market provides that inventories shall not be written down below the point of normal profit, and is discussed later in this chapter.

Determination of Cost.—There are various methods of determining, first, what outlays are considered to represent cost of items purchased or produced, second, the portion of cost that initially should be applied to inventories, and third, the relationship between the cost of inventories and their movement under circumstances in which the identity of individual items is lost or disregarded. Depending upon the methods chosen and the trend of prices, the effects may vary widely under identical circumstances. Cost represents all the direct and certain indirect expenditures for items purchased, produced, or in the course of production for sale. The written-down amount of items in previous inventories which are still on hand is also considered to be cost. This is recognized not only by the Committee on Accounting Procedure of the American Institute of Accountants (Bulletin No. 29) but also by the Treasury for tax purposes, assuming, of course, that the previously written-down amount is acceptable for tax purposes.

Cost of Purchases.—The cost of purchased articles is generally understood to be the purchase price plus transportation charges incurred for delivery to the purchaser. In addition, there may be other costs which are properly an addition to the purchase price, such as import duties, insurance, warehousing and handling costs. All discounts in excess of 2 per cent should be deducted from the invoice price, as these represent nothing more than a mechanical device for

arriving at the purchase price; likewise, any applicable rebates, because of quantity purchases or for whatever other reason, should be deducted. Cash discounts of 2 per cent or less are usually taken into income as a credit to cost of sales or other income. They may be applied properly as a reduction of inventory cost; if so treated they reduce cost of sales in the statement of income.

The entire inventory of mercantile enterprises normally consists of purchased items. The problem of determining cost for inventory purposes may be a relatively simple one, based on running records of the cost of items purchased and sold, or it may be more difficult and require the retail method discussed hereinafter.

Cost of Production.—As opposed to mercantile companies, manufacturers must not only account for the cost of purchased materials but determine the cost of finished and semifinished products derived therefrom which also includes labor and a reasonable allocation of overhead. Because of the complexities of modern manufacturing processes, which frequently convert raw materials into products of a radically different nature or appearance, determination of costs requires an adequate but not necessarily a complicated cost system.

Material costs consist of direct or major purchased materials; produced materials consisting in turn of material, labor, and overhead; and indirect or minor materials which are frequently accounted for as overhead. Labor may consist only of the wages of employees directly engaged in production or it may include the wages of certain indirect and supervisory personnel which are frequently accounted for as overhead. Material and labor are commonly recorded in direct association with items or groups of items produced. On the other hand, overhead represents those costs which are difficult or impracticable to associate directly with units of production. Overhead may consist of indirect labor (wages of supervisory production personnel and of factory administrative personnel), of indirect materials (supplies and other small items not usually accounted for individually), of depreciation, normal scrap, maintenance, light, heat and power, certain taxes, and of the host of various expenses of running a factory which are necessary for production. Overhead is commonly thought of in terms of variable overhead, consisting of items which vary with production, such as indirect labor and materials, social security taxes, and power; and of fixed overhead such as rent, insurance, and real estate taxes. Overhead may be charged to the cost of the individual items of production in a number of ways, ranging from a simple percentage of direct labor to more complicated meth-

ods. Overhead should exclude selling expenses, interest, and all such general and administrative expenses that are not necessary for production. Overhead commonly includes production engineering and may or may not include engineering of a more experimental nature.

Methods of Finding Inventory Cost.—Practically every business enterprise maintains some records of its costs. It is recognized as a principle of good internal control, as discussed later in this chapter, that a cost system adequate for the needs of the business should be maintained. Costs are usually determined by items or groups of items as they progress through the plant; they may be charged directly to the product or charged initially to departments or processes and redistributed.

Actual Cost.—Theoretically, so-called actual cost systems include in inventory the applicable portion of all production costs incurred, but this is not entirely true in practice. Since the method is historical, and costs are not determinable until production has been completed, it is frequently necessary to resort to estimates and to more or less adequate records of performance to determine costs at intermediate stages of production. For example, if the period of process is long and complicated it is frequently difficult to relate the physical inventory to cost under an actual cost system, as there may be only a record of charges and credits to a particular lot in process. Consequently, for inventory cost purposes a formula has to be developed by recourse to historical or estimated individual costs by stages of completion, such as job or process cost records. Overhead particularly must be studied to develop a proper application to the inventory, although frequently in actual cost systems a standard or fixed rate of overhead is used.

Standard Cost.—Under a standard cost system, costs are predetermined or estimated in advance of production. Material costs are usually estimated from actual consumption data or from bills of material, labor from actual production records or from time studies, and overhead from estimated and actual expenses on the basis of operating at normal capacity, all usually figured at prices and wage rates current at the time the standards are set. Differences between actual and standard costs are accumulated in accounts known as variances.

For the purpose of inventory valuation, standard costs may be used merely as a basis for determining actual cost by adding back or subtracting the applicable variances. Variances should be studied

carefully to determine the amount to be applied to the standards; it may be that the variances of the period in which the inventory was produced are appropriate, or it may be preferable to use those of a more extended period. As a matter of mechanics, the application of the variances is customarily made on the basis of their percentage relationships to groups of items or to the inventory as a whole, and is segregated in separate accounts within the inventory.

On the other hand, if standard costs are realistically determined they may be deemed to represent useful costs properly carried forward to the subsequent period and thus be the basis for inventory cost. If the variances do not represent (1) differences between actual wage rates or actual material prices and the standards, or (2) differences between the actual normal operations performed or actual normal usage of materials and the standards, it may be considered that unfavorable variances (debits) reflect inefficiencies or abnormalities of one kind or another and should properly be charged off rather than added to inventory cost. The criteria for realistic standards reflecting normal operations should not be theoretical goals, possibly never realizable; they should represent that performance which may reasonably and practically be attained under operating conditions expected to prevail during the ensuing period. Favorable variations (credits) representing the excess of standard over actual cost, if material, should be applied as a reduction of standard costs insofar as they relate to the inventory. The authors consider that the proper use of standard costs is a progressive and desirable method of determining cost for inventory purposes. It exemplifies well the principle of carrying forward only the useful cost of an inventory and may be helpful in the determination of market.

The Retail Method.—The retail method of determining cost differs from other cost systems in that the detailed records are kept in terms of selling prices and restored to cost by application of percentages which express the relationship of total selling prices to total cost. Proper operation of the method, through application of marked-down selling prices, results also in inventories closely approaching the lower of cost or market, and the method is acceptable to the Treasury for tax purposes. As the name implies, the method is used by retailers and others who keep their stock priced for resale; use of the method eliminates the maintenance of another complete set of records to determine cost.

Common Products and By-Products.—Many manufacturing processes result in more than one product from the same material, par-

ticularly in the chemical, lumber, packing, canning, oil, and leather industries. There are two acceptable methods of allocating cost in such instances: (1) on the basis of the relative values of the materials produced, and (2) on the basis of the relative estimated costs. While the first method is more common and is an acceptable method of determining cost for inventory purposes, it may not always be representative of what each of the common products costs.

While the allocation of costs based on sales prices is a recognized practice in the case of actual joint products, this method should not be used merely as a means of equalizing the recorded rates of profit on the several items in a line of merchandise. To do so produces erroneous information not only as to the relative profitability of the various items in the line, but may materially distort the amounts at which inventory is stated, as well as the results of operations for the period under review.

When by-products do not represent more than a small part of the total production, the so-called "by-product" method of accounting for them is practicable and reasonable. Under this method, no part of the total cost is allocated to by-products; they are valued immediately on production at selling price, and over-all cost of all products is correspondingly reduced. The remaining over-all cost is then allocated to the primary product or products.

Overhead Methods.—In practice there is great latitude in the application of overhead to inventories. On the one hand, it is generally accepted that all overhead should not be charged off as incurred (Accounting Research Bulletin No. 29), and on the other, it is very rare that all items of overhead are appropriate to apply to inventories. As a corollary to the principle that all overhead should not be charged off, there is, in the authors' opinion, a presumption against the exclusion of reasonably determined overhead costs from inventory. The exclusion of such costs may sometimes be tantamount to a reserve which reduces the inventory below an accepted basis; such reserves are discussed in Accounting Research Bulletin No. 31, issued in October, 1947. There has recently been further support of the method of charging off fixed overhead as incurred and of applying to inventories only such items as vary with production; while this method is not widely in use and is not generally recommended, it may have merit under certain circumstances.

As stated previously, overhead may include all the indirect expenses which are necessary for production, but should exclude all selling expenses and any general and administrative expenses not

related to production. In the application of overhead under an actual cost system, studies should be made to determine abnormal or unusual items, as well as those which do not relate to production, and to establish the relationship of operations during the period in which the inventory was produced to the normal level of operations. For example, abnormal scrap, unusually large repairs, or production at 50 per cent of capacity may well require adjustment in the application of overhead.

Many enterprises, no matter what the type of cost system in use, have adopted standard rates of overhead. These rates are commonly applied to direct labor hours, machine hours, or some other acceptable basis for absorption, and are usually computed on the assumption of normal operations of the plant. Usually such standard rates are preferable to redeterminations of actual rates which, over short periods of time, may fluctuate radically and abnormally. Overabsorbed overhead should be applied ratably as a reduction of inventory and cost of sales, while underabsorbed overhead is usually charged off unless there is some good reason for its application to inventories. The authors have not attempted in this book to explore the many ramifications of overhead methods, but rather have attempted to outline in principle what should guide the accountant under the usual circumstances.

Intracompany and Intercompany Profits.—Transfers of materials between departments or branches of the same enterprise are often treated as sales in the accounts, and when the transfers are made at above cost, an element of unrealized profit is introduced in the book amount of the inventory. This element should be removed. Elimination of intracompany unrealized profit is frequently accomplished by means of a reserve. Elimination of intercompany profits from consolidated inventories is discussed in Chapter 21.

Methods of Relating Inventory Cost to Inventory Movement.—The purchase price or production cost is frequently not the same for identical items in the inventory, and each may be subject to constant change. It is usually not feasible or desirable to maintain in the accounts identification of the various items and their cost. Some method must be devised of relating cost to the movement of inventory through production and into cost of sales. Aside from specific identification, these methods involve different assumptions as to the flow of inventories and, depending upon the method and upon the changes in price levels, may have widely different results.

Specific Identification.—When custom or contract work is involved, after the initial issue of material from stores, there frequently is correspondence between the physical identity of the product which the customer ultimately receives and the accounting record thereof; in these instances it is desirable to use the method of specific identification. It is usually not good practice to attempt the method in violation of the normal physical flow or when the identity of the various lots becomes commingled, as this may lead to selection of the lot with the most favorable cost.

First-In, First-Out.—The first-in, first-out (Fifo) method is based on the assumption that the goods first received or produced are the goods first used or sold; consequently, any inventory remaining on hand at the end of the period is priced at the latest cost of that quantity.

Although frequently the assumption of Fifo is in accordance with the actual flow of the inventories, it may be exactly the opposite, for example, when bulky materials are placed on a pile and the most recently received unit is used first. When the turnover is rapid, it may make no particular difference as to conformance with actual flow whether Fifo, specific identification, or the average cost method is used, particularly if averages are determined frequently.

Average.—The average cost of an inventory is determined by adding the quantities and costs of the items in the opening inventory to purchases or production during a period, determining the weighted average for each item, and applying such weighted average to consumption or sales. Averages are usually determined monthly; more than one average may be used for identical items in different locations. This method may be appropriate where large quantities of raw materials are on hand and their identity is lost, in that it does not assume a particular physical flow of materials which may not actually take place.

Last-In, First-Out.—The Lifo method assumes that current purchases are used for current sales, and that consequently the most recent purchases should be charged against current sales. This method obviously results in an inventory valued at the cost of the earliest acquisitions as contrasted with the first-in, first-out method, and consequently is known as "last-in, first-out." The practical effect of Lifo over a period of rising prices is to eliminate from inventory an amount somewhat corresponding to what would otherwise be the increase in the inventory under most of the other methods of relating cost to movement. Lifo is an accepted method; its use, however, may

produce such startlingly different results from the other methods that it is important that the reader of the financial statements understand its implications and effect. Lifo has been adopted by many enterprises in which the price of basic raw materials determines the price of the finished product—such as processors of nonferrous metals, oil producers, and cotton textile manufacturers.

Since Lifo is an acceptable method for federal income tax purposes, subject to the approval of the Commissioner, those who adopted the method prior to the war may have saved substantial sums in excess profits taxes, if prices increased during the period of this tax, and may have postponed or saved normal tax on a substantial amount of inventory appreciation. Thus there may have been a powerful tax incentive for the adoption of Lifo, and probably a great many more taxpayers would have adopted it if it were not for the requirement that inventories on this basis may not be written down to market for tax purposes, should market ever be below cost on the Lifo basis. This requirement might more or less permanently deny a deduction for an inventory write-down that would otherwise be allowable, and removes some of the incentive for the adoption of the Lifo method during a period of high prices. The use of Lifo for tax purposes also requires that it be used in the taxpayer's financial statements. Under the regulations, it is permissible in the accounts to deduct a reserve equal to any excess over market from Lifo inventories, but as stated above, such a reserve is not deductible for tax purposes.

Lifo may be used not only for basic raw materials but for the labor and overhead content of inventories. Recently the Treasury has recognized the right of retailers on the retail method to use Lifo by application of appropriate price indices.

It is good practice to provide reserves for the excess of current replacement costs of inventories which have been liquidated, over cost determined under Lifo if the intention is to restore all or part of the quantities liquidated when materials become available. This practice produces results similar to those produced under the base stock method in that basic quantities are valued at basic price. The refund provisions of the Internal Revenue Code [section 22 (d) (6)] may be applicable to such excess replacement costs, if inventories, involuntarily liquidated prior to January 1, 1948 because of war conditions, are replaced prior to January 1, 1951. Before providing such reserve for inventory liquidation after January 1, 1948, a company on the Lifo basis for federal income tax purposes should be sure that the reserve is provided and shown in such a way in its financial

statements that it does not jeopardize its right to continue on the Lifo basis for federal income tax purposes.

Other Methods.—The methods discussed above are generally accepted for the relation of inventory cost to inventory movement; in practice the public accountant will sometimes encounter variants or combinations which may or may not be substantially equivalent to the accepted methods. One important consideration in weighing the acceptability of a method is that it should eliminate discretionary charges or credits to income. While the normal or base stock method, which has been in use for some time in certain industries, closely resembles Lifo in certain respects, it differs in others and is discussed later in this chapter.

Determination of Market.—As stated previously in this chapter, under the lower of cost or market rule, inventories are carried forward at amounts not in excess of useful cost, which may not exceed market. For this purpose market means the lower of:

1. Replacement or reproduction cost, or
2. Net realizable value

except that it should not be so applied as to reduce the inventory below the point at which a normal profit may be expected to be realized. Obviously, the establishment of this point is necessary only when replacement or reproduction cost is lower than net realizable value.

The above is the effect of the rule which is stated in Accounting Research Bulletin No. 29, issued in July, 1947; this same rule has been in effect for many years except for the new provision that the inventory should not be reduced below an amount which will yield a normal margin of profit. The lower of cost or market is recognized for federal income tax purposes, but as yet the Treasury does not impose the new limitations referred to above.

When the net realizable value becomes the measure of market, the bulletin does not, as a general rule, sanction a further write-down by an allowance for an approximately normal profit margin. The Committee states that the bulletin is intended as a guide rather than a literal rule. An illustration of an acceptable departure is the use of the retail inventory method which carries forward marked down items at an inventory price which, it is expected, will yield what may be called the normal margin of gross profit for that class of goods or the particular department. Since the Committee considers that the retail inventory method, if adequate markdowns are currently taken,

accomplishes the objectives of the bulletin, it seems clear that the Committee does not intend the bulletin to prohibit, when under the general rule net realizable value would be controlling, the writing down of an inventory, or a part thereof, to an amount which, it is expected, will yield an approximately normal margin of profit if the circumstances are such as seem to justify such a procedure.

It is understandable that the Committee could not lay down precise rules which will cover every case. In the authors' opinion, instances will be encountered in which it is good business and good accounting to write portions of an inventory down to a point that may yield an approximately normal margin of gross profit, even though replacement cost is not below actual cost. The authors are also of the opinion that, in many instances, to write down portions of an inventory below net realizable value would be unjustified and would merely result in shifting profits from one period to the succeeding period.

Replacement or Reproduction Cost.—The term replacement cost is generally used in connection with items purchased, while reproduction cost is generally used in referring to the manufacture of a finished product. A retailer would replace his inventory. A manufacturer would replace his raw materials but would reproduce his finished product.

The term replacement cost contemplates buying in the open market; therefore, the elements of salability, desirability, quantities, and other factors are to be considered. It is important that the quotation at market should reflect the customary volume purchased at one time as well as the customary terms and manner in which purchased. It should include all costs necessary to bring the goods to their usual location, such as freight, duties, and other expenses incidental to acquisition.

Occasionally, situations may be encountered where there is no true replacement market. For example, large tobacco companies buy green tobacco leaf at the end of the growing season, but this leaf requires processing and aging of from eighteen months to three years before it can be used. The partly processed and aged tobacco cannot be purchased in quantities required to replace the leaf tobacco inventories of the larger companies, and dealer quotations for small quantities are not indicative of the replacement value of these inventories.

Reproduction cost means the actual expenses of reproducing the identical goods in the identical quantity and quality, irrespective of

the advisability or desirability of duplicating them. In an advancing market, the sales value of the finished product may not rise in proportion to increased reproduction costs, and in a declining market the sales value of the finished product is sometimes below reproduction cost. Accordingly, while reproduction cost affords an important check on inventory prices, there is always the possibility that net selling prices may be lower than reproduction cost.

Net Realizable Value.—Accounting Research Bulletin No. 29 defines net realizable value as the "estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal." The Committee did not discuss the question of what should be considered costs of disposal. The authors believe that as a minimum, all directly identifiable costs, such as packing, shipping, and salesmen's commissions, should be included.

Point of Normal Profit.—Theoretically, one would expect some disagreement as to what a normal profit is, but in practice this point can be established without too much difficulty by reference to performance over a recent period of time or to budget figures. If the executives of the business are slightly optimistic about the normal margin of profit the only effect will be a slightly conservative inventory valuation; there will probably be much less room for discretion and judgment in the computation of this factor than in the initial determination of cost. The normal profit should, of course, be determined exclusive of nonoperating income and deductions.

Application of Market to the Inventory.—There are two ways to apply the market test to the inventory: (1) to each item or to small groups, and (2) to large groups of items or to the whole inventory. For some years the former method was followed in theory but for many enterprises it was not practical. It is now generally recognized that either method may be used. Obviously, the item-by-item method may result in a lower inventory since many individual items may be lower than market, yet in the application of the market test to a group such items might be offset by others whose market was higher than cost. The best practice in the application of market continues to be the recognition of the logical groups or classifications of individual items into which the inventories in the particular business naturally fall. Treasury Department regulations provide that the lower of cost or market value be applied to each article in the inventory for tax purposes, but in practice this requirement is not insisted upon when it is obviously not practical.

Purchase Commitments.—The practice, formerly followed by some enterprises, of providing for losses on firm unhedged purchase commitments for goods for inventories should now be followed generally (Accounting Research Bulletin No. 29). These losses should be provided for in the same way as inventory losses. As a matter of fact, it is impossible to measure losses in certain inventories unless the inventories together with the commitments are compared with firm and probable sales orders. Frequently, the initiation of such studies leads to the cancellation of purchase commitments at smaller losses than would result from purchasing, processing, and selling the materials. Very often purchase commitments are outstanding for obsolete or unsalable merchandise, delivery of which has been delayed because management did not wish to recognize the loss.

Other Methods of Valuation.—There are other accepted methods of inventory valuation which may result in inventories stated below or in excess of the lower of cost or market basis.

Normal or Base Stock.—This method, which is in accordance with generally accepted accounting principles, has long been used by certain companies engaged in processing basic raw materials, although its use for federal income purposes has been denied by the Treasury and the courts. Subsequently, Congress included in the tax law the Lifo provisions which, to a degree, represent a substitute for the normal or base stock procedure.

Both normal or base stock and Lifo methods have as their primary objective elimination from income of so-called "inventory profits and losses" resulting from changing price levels.

The normal or base stock method differs from Lifo in several respects. Under the normal or base stock method a basic normal inventory, required at all times for normal operation, is fixed as to quantity and price. Increases above such fixed quantity, if not resulting from increase in plant capacity or change in process, are ordinarily considered as reflecting management's appraisal of future markets, availability of materials, or other conditions and, therefore, reasonably priced under one of the more conventional cost bases or at market, if market is lower. Under the Lifo method, such increases are priced at the price level obtaining when the increase occurred, and the most recent increase is considered the first to be sold when quantities decline.

Under the normal or base stock method, if quantities are reduced below those considered normal or basic, and such reduction does not result from a change in capacity or process, a reserve is provided in an

amount measured by the difference between the basic fixed price and the then current market price applied to the deficiency in quantity.

Conditions which make the use of the normal or base stock method desirable are:

Constant maintenance of substantial quantities of homogeneous raw materials;
Large raw material content in cost of the finished product;
Quick reaction of selling prices of finished product to fluctuations in the replacement cost of raw materials;
Relatively large investment in inventories;
Relatively slow manufacturing or treating processes.

Selling Prices.—While the valuation of inventories in excess of cost may seem to violate the rule against anticipation of profits, there are some cases where inventories are stated at selling prices. Accounting Research Bulletin No. 29, July, 1947, states the opinion of the committee that:

> . . . . precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability. Where goods are stated above cost this fact should be fully disclosed.

Although the practice is accepted when the above conditions are met, the trend in current years appears to be toward the more conventional methods of presentation. Also, the practice at the present time appears to be confined to such companies and products as the following:

Mining companies—gold, silver, copper, lead, and other metals;
Sugar companies—sugar and molasses;
Packing companies—fresh meats and other products;
Oil companies—crude oil;
Companies handling cotton and grain.

Many companies in these groups do not follow the practice and some apply it only to certain portions of the inventories.

The selling prices to be used as a basis for inventory valuations should be computed after deducting estimated costs of completion and disposal. In the authors' opinion, mere difficulty of determining approximate cost is the least persuasive of the justifications for this method, since there may be comparable difficulties in the determina-

tion of costs of other inventories. The primary justification for the method is the consideration that the inventory is immediately marketable at quoted market prices.

Inventory Reserves.—Inventory reserves fall into two classes: (1) those that reduce the inventory below a generally accepted basis or provide for general contingencies, such as future declines in prices, and (2) those that reduce the inventory to a generally accepted basis. Reserves in the first category should not be charged against income, but should be regarded as appropriations of surplus (Accounting Research Bulletins No. 31 and No. 35 issued in October, 1947 and October, 1948, respectively) and should not be shown as a reduction of inventories on the balance sheet. Reserves in the second category are usually resorted to as a matter of mechanics because it is frequently inconvenient and sometimes impracticable to reduce the inventory accounts in detail.

There may be possible or probable losses in an inventory which are not revealed by a physical inventory or which may have occurred since inventory-taking, and consideration should be given to establishing a reserve of the second category for these losses. Frequently, such a reserve can be projected from experience or otherwise reasonably estimated, to provide for physical shortages since the date of the physical inventory, scrap or spoiled work not reported, obsolescence or deterioration not yet apparent, and other similar factors.

Relationship of Commodity Futures to Inventories.—In certain industries manufacturers may sell and buy futures on commodity exchanges to hedge their purchase and sales orders against losses from fluctuations in market prices of raw materials. Futures are generally bought to hedge the price of raw materials required for goods sold for future delivery; futures are generally sold to hedge purchases and commitments to purchase raw materials. While futures are usually contracts for the purchase and sale of stated quantities at specified prices and dates of delivery, in order to avoid physical delivery of materials involved they are customarily closed out prior to maturity; settlements are made through the exchange for the gain or loss at the time they are closed.

If futures contracts are for the same commodities, but not necessarily the identical grades, as those carried in the inventories, and are entered into as part of a plan designed to decrease operating risks, they may be accounted for in conjunction with cost of materials. Realized gains may be credited and realized losses may be charged to cost of sales.

Unrealized profits or losses on futures purchased as protection against sales commitments or on sales of futures made as protection against commitments to purchase raw materials are usually not recognized in the accounts but the facts may be stated in the footnote.

If the futures contracts are entered into for a purpose other than for hedging inventory risks, they should be accounted for separately from inventories, and profits and losses therefrom should be reflected as other income or other deductions. Unrealized profits should not be taken up in the accounts as such. Unrealized losses should be recognized in the same way as those on regular purchase commitments.

Consistency.—As previously indicated, the different methods of valuing inventories may have widely different effects and within the method adopted there is frequently a large area of judgment and discretion. This does not mean that management may or should adopt annually the method or the interpretation that best pleases it; it means that the inventory methods most advantageous and suitable to the enterprise should be followed consistently from year to year if the statement of income is to present fairly the results of operations.

On the other hand, every business will make some changes from year to year in striving to improve its determination of inventories, and such changes should not be judged inconsistent by the public accountant unless they constitute a real change with material effect in the current period or an anticipated material effect in succeeding periods. For example, a change from the first-in, first-out method to the average cost method may have material results; the effect of a change in the treatment of certain overhead items may not be material. Changes which represent material inconsistencies or which affect the comparability of the financial statements in a material way should be disclosed, as set forth under the fourth section of this chapter.

The Treasury stresses the importance of consistency of method as will be noted from the following regulation [Sec. 29.22(c)-2, Reg. 111]:

> In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

INTERNAL CONTROL

Introduction.—The size of the usual investment in inventories and their nature should make it obvious that good internal control is desirable and necessary, yet public accountants still encounter a surprising reluctance on the part of some clients to improve their inventory control, although the same clients may not hesitate to adopt suggestions as to cash or receivable procedures. This reluctance probably has its roots in the time when inventories were the private domain of the production man, who was apt to resent the intrusion of accountants and their efforts to control inventories. Then, too, the fact that inventories consist of tangible property, unlike most other current assets, and that they usually are made up of a great many different items which may change radically in appearance or nature in the course of manufacture, has led to reluctance on the part of some businessmen to adopt good inventory control. Their attitude in brief was either that it could not be done, that it should not be done, or that it was too expensive.

It is now generally recognized that the establishment of good accounting control and other allied procedures is frequently an invaluable aid to production control and to protection of inventories. The requirements of knowing currently what you have, where it is, and what it cost, and the requirements of other internal control procedures may be expensive, but it may be more expensive not to have control. Naturally, considerations of economy may prevent the adoption of some of the features of control discussed in this chapter.

In the authors' opinion, adequate internal control of inventories should embody the following:

1. Control of receipts and shipments,
2. Control of consumption and production,
3. An adequate cost system,
4. Perpetual inventory records, and
5. Periodic counts of inventories.

In the following pages the discussion is from the point of view of a manufacturing enterprise; however, this discussion covers the usual aspects of internal control of other enterprises. The authors emphasize the unimportance of the particular procedure or its form; the achievement of the control itself, which may frequently be accomplished in different ways, is important. The allied subjects of internal control of purchases and pay rolls are discussed in Chapter 20.

Control of Receipts and Shipments.—Responsibility for the receipt and inspection of all incoming materials should be centralized in one department, independent of the purchasing, stores, and shipping functions whenever possible. This organizational independence provides a cross check on the performance of these departments and reduces the opportunities for improper diversion of assets. Receiving department procedures at a minimum should include the following: (a) inspection of all receipts as to quantity and quality and a comparison thereof with a copy of the authorized purchase order; (b) preparation of a receiving report with the required number of copies; and (c) the prompt transmission of the materials to stores or other authorized recipients, obtaining in return signed receipts to be maintained on file in the receiving department.

The receiving report should be issued in numerical sequence and ordinarily states the name of the vendor, a description of the articles received, date of receipt and purchase order number. It sets forth any exceptions such as damages in shipment, failure to comply with specifications of the purchase order, and shortages as compared with the packing slip. The report should be signed by the employee who makes the check; where exceptions are substantial, it is advisable to have another employee recheck the material, since the receiving report will be the basis of any claim against the vendor or carrier.

The flow and use of the receiving report is important and will be discussed in some detail. Normally, the original and four copies of the receiving report and inspection report, if the two are not combined, should suffice although in certain circumstances more may be required. The original should be retained in the receiving department as a permanent record of the receipt, preferably bound in numerical sequence following the chronological order of receipt. The numerical control not only facilitates reference but also provides a measure of control by requiring an accounting for reports issued. The chronological series will also aid in simplifying the inventory cut-off on receipts. One copy should accompany the material to the stores division where the storekeeper should make an additional check of the material prior to signing a receipt therefor. This copy will usually be the basis of an entry on his stores inventory cards. Either the storekeeper's or another copy should go to the accounting department as evidence of receipt in support of the recording and eventual payment of the vendor's invoice, although it is frequently customary, to avoid the loss of cash discounts, to pay invoices of certain responsible vendors prior to the receipt or final inspection of materials. A third copy should go to the purchasing department.

This copy provides information for any follow-up required and also may be posted to the purchasing department's record of commitments. The final copy goes to the traffic department to be used in examination of freight bills and as supporting evidence for any claims against carriers on merchandise damaged in transit. All copies should be in exact agreement and the distribution procedure followed consistently even when the material has been rejected and returned to the vendor.

All shipments out of the plant, under all circumstances, should be covered by an authorized shipping advice or material release. In addition to the approved shipping advice, a customer's invoice checked for quantities, price, extensions and terms, a stock requisition, and a packing slip should be required documentary support for the shipment. Simultaneous preparation of these papers provides the simplest and most reliable means of correlating the separate phases of the transactions. The forms should be prenumbered and control maintained by the accounting department, such control to include the filing of all voided forms. All shipping advices should have accounting department approval as assurance that billing of the shipment has been effected. The material requisition, similarly approved, is retained by the storekeeper in support of the issuance of material to the shipping department whose representative will sign the requisition acknowledging receipt. The shipping department, in addition to maintaining a complete file of all shipping advices, should attach thereto all other evidence of shipment such as bills of lading, copies of freight bills, and trucking bills. The details of the records kept as relating to routing, carriers, and other pertinent shipping data will depend on whether the traffic department operates independently or within the shipping department's scope of authority. It is important that the procedures established are at no time circumvented on the pretense of expediting shipments, and that the procedures apply to all types of sales, including sales to employees, scrap and waste sales, sales of equipment, and no-charge shipments.

Control of Consumption and Production.—Proper operation of the receiving and shipping departments may be thought of as the first steps in internal control that govern the flow of materials from and to the outside. If management is to control the materials within the plant, and if it is to receive reports of current operating results, procedures usually must be maintained governing the consumption of raw materials, of transfers from one process to the other, and of production of finished goods. Materials issued from stores should be

supported by requisitions approved by authorized employees with receipt of the materials acknowledged by recipients. Normally, one copy of the requisition will be retained by the storekeeper and one or more copies forwarded to the accounting department. Practices as to controlling work in process vary greatly; the accounting department should be informed of the quantities of finished goods produced and of transfers from one important process to another; often it has been found desirable and feasible to have requisitions for certain transfers throughout the plant.

An Adequate Cost System.—Good internal control presupposes an adequate cost system for the determination of the current entries in the inventory controlling accounts as well as for the determination of the cost of the individual items or groups of items produced. The cost system should be tied in with the general books of account and is necessary not only for the production of adequate monthly or other interim financial statements but also for the maintenance of accurate perpetual records. An adequate cost system will be susceptible, through a reserve or otherwise, of periodic adjustment to market, if market be lower than cost. The type of cost system in use will depend on the needs of the business; simplicity should be the keynote, for an overcomplicated system will often bog down from its own weight. From the point of view of control, there is much to be said for so-called standard or other cost systems which involve a budgetary principle or which predetermine costs, some of the advantages of which may be as follows:

1. More prompt pricing of physical inventories, since costs do not have to be computed therefor except for the study of variances;
2. Current control over production costs through study of variances;
3. Better understanding of production through studies for the purpose of setting standards.

Some cost systems introduce a hidden factor of conservatism, to allow for shrinkages and other production losses, and such a factor is often deliberately overestimated, so that physical inventories may be in excess of the book controls. While it is undoubtedly good practice to be conservative in interim financial statements, the authors believe that better control is obtained if estimates are made as accurately as possible and any allowances for conservatism are reflected in a reserve account pending year-end adjustment.

Perpetual Inventory Records.—When the accounting department has full current information as to the movement of materials and an adequate cost system, it is in a position to maintain not only summary accounts for inventory balances, but also details of quantities and dollar amounts for each item or groups of items in the inventory in perpetual inventory records. Many manufacturing and merchandising concerns have found it to their advantage to maintain perpetual inventory records, although the types of such records vary greatly. Perpetual inventory records offer three important advantages:

1. They serve as a check on the custodians of the inventories. Awareness by a storekeeper of the existence of an independently maintained record tends to discourage theft or misuse of inventories and to prevent laxity in conforming to established procedures.
2. They provide information essential to adequate purchasing and production controls and related sales policies. Purchasing policies are dependent largely on the requirements of the production program. Good production planning in turn requires the maintenance of production materials at a level high enough to assure efficient manufacture and low enough to avoid overinvestment. A perpetual record also is useful in determining the adequacy of finished stock to meet customers' requirements and in the detection of overstocks.
3. They facilitate physical inventories. Frequently periodic counts during the year are a satisfactory substitute for a complete physical inventory at one time. Furthermore, if complete physical inventories are taken, the differences between them and the general ledger accounts can be localized, and may sometimes be investigated without a costly restudy of the entire inventory to ascertain the cause of the difference. The perpetual inventory records may be extended at any time for comparison with the general ledger balances.

To maintain perpetual inventories in agreement with controlling accounts, all receipts, withdrawals, and adjustments must clear through the accounting department. Monthly summaries of all materials received, both by purchase and by transfer, duly authorized requisitions, and adjustments arising from spoilage, obsolescence, and other causes, should be prepared in support of the monthly entries to the controlling accounts.

Physical Inventories.—Good internal control requires the taking of a physical inventory at least annually; the term physical inventory comprehends not only a physical count but also the pricing or the translation of the count into dollars. A complete count of the inventory of a company, plant, or department may be made at one time while operations are suspended or, if perpetual inventory records are maintained and other conditions are satisfactory, periodic counts of selected items may be made during the year, covering all items in the inventory at least once. Sometimes both types of inventory-taking are employed. Since the two methods involve somewhat different techniques, they will be discussed separately. A physical inventory is not a substitute for the book figures, but rather a complementary control device to check their accuracy and to provide for their correction. Physical checks frequently will not be in exact agreement with the records, for it is to be expected that differences will arise from spoilage, obsolescence and shrinkage not previously recognized, and from errors in recording. Employees, however competent, are bound to make some mistakes, and the physical check provides about the only practical means of correction.

Inventories Taken at One Time.—A complete inventory at one time is a large undertaking and requires the cooperation of the production personnel, since it usually means shutting down the plant and physically rearranging work in process and other inventory to facilitate counting. Since it is essential that responsibility be placed upon someone with authority, it is usually desirable to have one of the top production men responsible for rearranging the stock and making available the employees who are familiar with it. It is frequently the practice for production personnel to count the inventories as they are rearranged, particularly when rearrangement is equivalent to a count; these counts should then be checked by personnel independent of those maintaining the perpetual records. Or the initial count and the second count may be made at the same time. The important principle is to have a second count by individuals independent of both custodianship and record keeping.

An almost invariable requirement for a good physical inventory is the preparation in advance of a written program which can be clearly understood by the average employee, and which should include instructions pertaining to:

(a) Good physical arrangement as a means of simplifying the count,

(b) Proper identification and description of stock,

(c) Segregation or proper notation of slow-moving, obsolete, or damaged goods,

(d) Control, preferably numerical, of the inventory tags or sheets,

(e) Practices to be followed in the verification of individual counts, and

(f) Practices to be followed in obtaining a proper cut-off of receipts and shipments.

In addition to the above, which relate to the counting of the inventory, the accounting department should be instructed as to:

(g) Summarization of quantities,

(h) Pricing, and

(i) Independent check of summarization and pricing, including extensions and footings.

Special attention may be required in the program or in supplemental programs, to consignments in or out, goods in transit, goods in warehouses and in branches.

It is important that the forms used in the inventory-taking be simple enough to be understood by the employees for whose use they are intended; there is frequently a tendency on the part of those who design the forms to make them too complicated. Requirements vary, but experience with previous inventories should be drawn upon and applied to the design of forms which will facilitate inventory taking. It is usually desirable and sometimes imperative that the forms on which the initial count is recorded be numerically controlled.

The counting and pricing of inventories, and the preparation of summaries should be supervised to determine that the procedures are adequate, and are being properly carried out. A competent internal audit staff can be utilized to advantage in performing this policing function. When there is no internal audit staff, other responsible personnel should be assigned to this task.

The mechanics of counting will vary. Seldom, if ever, can all the individual items in an inventory be seen and counted; they are frequently in the packages or cartons in which they were purchased or are held in finished stock, and often in bins in large numbers or in large stock piles which physically cannot be weighed or counted. The only rule which can be laid down is that a reasonable number of items should be counted; some packages should be opened, and some items inspected, particularly if there are any unusual circumstances.

It is the responsibility of the accounting department to investigate differences between physical and book inventories. In investi-

gating these differences the possibility of leakage or pilferage should be considered. However, the books may be right and the count wrong and adjustments should not be made without investigation.

Inventories Taken Periodically Throughout the Year.—As stated previously, when good perpetual records are maintained and other circumstances are favorable, physical counts may be made periodically throughout the year, covering all items at least once in a year. When this is done, the perpetual records are priced, extended, and summarized for comparison with general ledger accounts, at or near the end of the fiscal year. Procedures employed in making periodic counts during the year differ from those when inventories are taken at one time. Rather than enlisting production personnel to rearrange and count all the stock in the plant, counts are usually made by relatively small groups of employees who soon become experts and possibly spend a large part of their time counting inventories.

There are in practice two major difficulties to be overcome if good periodic counts are to be made:

1. It is frequently difficult to obtain a good cut-off. Unless the perpetual records are posted promptly and accurately, the counts will result in apparent differences which are actually delays in recording.
2. Unless the physical arrangement and the perpetual records correspond, it is difficult to obtain a good count.

For example, in one company periodic counts were made covering the entire inventory twice in one year, yet the differences indicated by the counts were substantial in a large percentage of the items. The perpetual records showed the various parts making up finished product without indicating whether they were accounted for as stores or had been transferred to work in process, and without indication of physical location or stage of completion. Obviously, the differences were the result of inability of the counters to find or to distinguish the items they were looking for, and in addition they were vexed by problems of cut-off.

It is sometimes practicable to combine periodic counts of one or more sections of the inventory, such as raw materials, stores, and finished stock, with a complete inventory at one time of work in process. Generally speaking, unless the results of periodic counts are uniformly good, these counts should be relied upon not as a substitute for, but as a complement to, a complete inventory at one time.

Employees who are making periodic counts usually should not know what quantities are shown on the perpetual records; this eliminates the obvious tendency to report as a count what is indicated on the perpetual record.

Other Features of Internal Control.—While the major aspects of accounting control have been discussed in the five preceding sections, there are others which may be important, depending upon the size and character of the enterprise.

Production Control.—The requirements of management to control inventories and purchase commitments in relation to sales volume will be based upon a correlation of the inventory records and the purchase commitment records, usually maintained by the purchasing department, with records of sales orders from the sales department. The avoidance of excessive, unbalanced, and obsolete inventories frequently depends upon maintenance of good production control records which too often are merely collateral records not tied in with the accounts. Various other devices are helpful, such as the use of maximum and minimum stock levels, special studies of rates of turnover, and analyses of inventory balances to determine the number of months' supply on hand. Frequently, other production control devices may be tied in with the accounting records so that their functioning is more or less automatic and subject to test.

Approval of Adjustments.—Inventory adjustments should not be made without the approval of a responsible official, preferably the chief accountant, whose functions are independent of storekeeping. Significant discrepancies between physical and book amounts should be promptly investigated and the causes determined. Inadequacies in the cost system, laxity in conformance to procedures covering the receipt, storage and issuance of the materials, theft and errors in recording are among the possible causes. Equally as important as the detection and correction of errors are the steps taken by management to avoid possible recurrence of similar discrepancies. Adjustments made during the year and at the annual inventory should be set forth clearly in special inventory adjustment accounts and adequately described in the internal reports, thereby providing management with concrete evidence as to the effectiveness or ineffectiveness of inventory control procedures.

Reporting of Slow-Moving, Obsolete, Overstocked, and Damaged Items.—An important requirement of a properly functioning inventory system is the current reporting of items which do

not move in the usual course of business, for whatever reason. These reports should originate from storekeepers and from those responsible for work in process and finished goods; they should be required at specified intervals so that recognition can be given to the facts, and recurrence prevented, instead of relying upon the annual inventory, at which time it is usually too late for preventive measures.

Inventories Not on Premises.—Inventories not on the premises normally include consignments out, inventories in hands of suppliers, in warehouses, with finishers, and in branches. These classifications of inventory should be carried in separate accounts and should be supported by perpetual records. Additional control procedures may include monthly inventory reports, confirmation, and periodic physical tests. Controls relating to receipts and shipments should be similar to those discussed earlier in this chapter, even though the shipments may be on memorandum only. Materials in public warehouses should also be supported by warehouse receipts which may be compared currently with the accounting records. To avoid possible duplication special attention should be given to goods in transit.

Inventories Belonging to Others.—All inventory belonging to others should be clearly identified, physically segregated, and scheduled as part of the physical inventory procedure. If the amount is significant and the activity frequent, a perpetual record should be maintained with documentary support for all entries. Records of accountability for the property of others should be maintained more exactly than those for one's own property, particularly if there is commingling.

Defective Work, Scrap and Waste.—Good production control requires a system of inspection whereby defective work may be detected promptly to prevent further accumulation of costs in completing a substandard or defective product. If such defective items can be utilized in some other manner or can be sold as seconds, they may be returned to stock. If not, they should be segregated and quantity control should be maintained pending disposition. Similar control should be exercised over scrap and waste materials. It is important to have proper supervision of the weighing and grading of scrap, as well as of the price received therefor. Numerous frauds have been perpetrated because of management's negligence in not maintaining proper physical and dollar control over this inventory.

Items Charged Off, but Physically on Hand.—It is a frequent practice to charge to expense, as purchased, certain types of supplies, such as small tools. These items, whether issued or on hand, should be under accounting or physical control and subject to the same requisitioning and inventorying procedures as other inventories. This also applies to items of doubtful value written off, but on hand.

Returnable Containers.—Returnable containers in which the company's product is shipped may be treated either as current assets subject to inventory adjustment, or as fixed assets depreciated over a reasonably short period. Containers on hand should be checked physically in the same way as other inventories. If charges to customers for containers are usually settled by the return of the containers, these charges should be carried on the books in a memorandum receivable account offset by a container liability account. This memorandum receivable should be credited and the container liability account charged upon the return of the container. Containers represented by such memorandum receivable and container liability accounts should be added to the inventory of containers. Also if cash deposits received on returnable containers are considered as current liabilities, the containers represented by such current liability should be included as inventory. However, if containers are seldom returned by customers, and billing has been made, there is justification for treatment of such billing as a sale. In addition to accurate counts, periodic physical tests should include inspection of the containers to determine their potential usefulness.

Physical Protection and Insurance Coverage.—Inventories are generally exposed to certain physical risks such as fire, theft, floods, weather, and spoilage, some or all of which may be insurable. However, the first line of protection is proper physical handling, storage, and guarding, the requirements of which vary so greatly that they will not be discussed here.

Unless the company is self-insured, the risks of fire and theft should be covered adequately by insurance, whereas other risks may or may not be covered depending upon circumstances. Proper internal control requires periodic analysis and reporting to management of amounts and insurance coverage of inventories in various locations. All policies in effect should be inspected periodically as to renewal dates. When co-insurance clauses exist, the total coverage should be maintained at least at the level required by such policies to insure the greatest return in the event of loss. The maintenance of

perpetual inventory records may be of great assistance in proving loss, particularly partial loss.

AUDITING PROCEDURES

Introduction.—Inventories are frequently the largest item of current assets; their valuation may be difficult and, within the limits of the principles of valuation, may require considerable judgment and discretion; and the ultimate reasonableness of valuations may depend upon subsequent events. Internal control of inventories is much more difficult than that for other current assets chiefly because inventories represent physical property which is constantly changing. Under the circumstances, it is entirely logical that the public accountant does not assume, and cannot be expected to assume, the responsibilities of an appraiser or stocktaker. However, the scope of generally accepted auditing procedures is such that the public accountant usually can form a well-founded opinion upon the inventories. Generally, appropriate auditing procedures include a review and tests of the system of internal control, analysis of inventory accounts, observation and tests of physical inventories where practicable and reasonable, and examination of the physical inventory records, including tests of the quantities and pricing.

Review of Internal Control and Other Preparatory Considerations.—The system of internal control in relation to scope of the auditor's examination of inventories is of great importance. For example, an adequate cost system makes it possible to localize the differences between physical and book inventories in terms of the various controlling accounts; perpetual inventory records make possible the further localization of such differences in terms of individual items or groups of items. On the other hand, the absence of both an adequate cost system and perpetual records makes it difficult to determine the reasons for inventory differences, and the auditor must examine the inventory account in greater detail, because many serious errors may occur when these controls are lacking. The lack of adequate control over certain items of inventory, such as scrap, may open the door to fraud or theft and, while their detection is not the primary function of the auditor, he should bring such possibilities to the attention of his client. In initial engagements considerable time should be devoted in advance of the physical inventory, if possible, to become familiar with the client's accounting procedures and internal control, and to study the business and its products.

Visit to Plants.—After general discussion of his client's accounts, probably the first step that the auditor will take on an initial engagement will be a visit to one or more of the principal plants or other place of business to obtain a visual impression of the manufacturing, warehousing, or retailing processes. In the authors' experience it is helpful to have seen the products to be inventoried in advance of the inventory-taking, and to have some knowledge of physical attributes of the product and how it is made, when reviewing the system of internal control.

Procedures in Reviewing Internal Control.—The more important features of a good system of internal control for inventories have been set forth earlier in this chapter, and Chapter 20 contains a discussion of internal control of purchases, expenses, and pay rolls, of which a large part usually relates to cost of production. The general form and methods of the auditor's review of internal control have been discussed in Chapter 5; insofar as inventories are concerned, it is important not only that the recorded evidences of internal control be reviewed but that procedures be understood thoroughly.

It may be relatively easy to establish through inquiry what features of internal control of inventories are nominally in force. It may not be quite so easy to ascertain whether they are actually in force, but the auditor can get reasonable assurance by tracing specimen recorded transactions through the various routines from purchase commitment to final sale, observing also, as the tests are made, whether current transactions are handled according to instructions. Analyses of the inventory accounts may be prepared or studied concurrently with the review of internal control. It is desirable for the auditor to have the manufacturing processes and the related factory records constantly in mind during his review and to refresh his understanding thereof by physical inspection; only then can he avoid misunderstandings that result from too much work at a desk and too little in the field.

A review of previous physical inventories will give the auditor a good conception of what the inventories comprise, where they are located, and how they are valued. Inquiry into previous inventory adjustments may furnish clues as to weaknesses in inventory control and may be helpful in shaping the audit program.

Plans for Physical Inventories.—The auditor should review and criticize constructively the client's written instructions for the physical inventory or suggest that such written instructions be pre-

pared if they have not been. The primary responsibility for a good inventory is the client's, and there is no substitute for clearly written instructions. It may be desirable for the controller or other accounting executives to hold instructional meetings with those who are to be in charge of taking physical inventories, to the end that such employees have a thorough understanding of the instructions as written. This procedure not only serves to expedite the taking of the inventory but also clarifies many points that cannot be spelled out in the instructions.

In planning for observation of inventory-taking the auditor must consider his manpower requirements and the timing of the inventories at the various locations. Obviously, manpower requirements are greatest at one time for the annual complete physical inventory, whereas they are least when only periodic counts are made. When the client's internal auditing staff participates in taking the physical inventory, the independent auditor may reduce his tests, and thus relieve his manpower problem.

Analysis of Inventory Accounts.—Occasionally, in conjunction with his review of the system of internal control, the auditor will prepare or review analyses of the inventory accounts for the period or for part of the period since the beginning of the year. These analyses may show by departments the charges to cost of production and the cost of the finished or semifinished items transferred. Entries in support of labor and material costs can be reviewed and traced to original data; factory overhead can be reviewed and tested and tied in with analyses of other accounts, such as depreciation reserves, tax accruals, and the like. Credits to inventory may be traced to cost of sales or to charges to the next department or to other accounts, and the basis of such credits examined. The extent of the auditor's tests will be governed by his examination of purchases and pay rolls (discussed in Chapter 20), by the extent of his examination of the physical inventory, by whether or not it is an initial engagement, and by the system of internal control.

The auditor customarily will analyze the various inventory reserve accounts, since analyses of these accounts will frequently give him information as to important matters of valuation.

Observation of Taking of Physical Inventories.—The observation by the auditor of his client's physical inventory taking is, where practicable and reasonable, a procedure required by present-day auditing standards. This practice was followed by many public accountants for years prior to October, 1939, when the American

Institute of Accountants approved the report, "Extensions of Auditing Procedure," which provided that the practice be thereafter generally accepted auditing procedure. As set forth in the preceding pages of this chapter, physical inventory-taking means either a count of the whole or sections of the inventory at one time, or periodic counts where perpetual records are maintained, or a combination of the two procedures.

Primary Objective.—The primary objective of the auditor's observation of inventory-taking is to ascertain, insofar as he reasonably can, whether an accurate inventory is being taken by his client. As stated above, the auditor is not a stocktaker and he cannot be expected to be an appraiser of, or expert upon, inventory quality, quantities, or condition. While the auditor's test counts are usually relatively limited, there may be instances in which, because of poor internal control, lack of responsible employees, or by request, the auditor will check a substantial part or all of the inventory quantities. It is frequently not necessary for the auditor to visit all branches of his client every year to observe the taking of physical inventories, if the internal control is good, and if the inventories are well supervised, or periodically tested by internal auditors or others. It is usually satisfactory to substantiate inventories in the custody of others by confirmation, but it may be desirable, in addition, to take a physical inventory of them, particularly if these inventories are substantial or if unqualified confirmation is not received from a responsible holder.

Inventories Taken at One Time.—To be satisfied that inventory instructions are being followed and a good physical inventory is being taken, the auditor should make tests indicated below:

(a) Good physical arrangement. The auditor should first make a general, brief inspection of the premises at the start of, or prior to, stocktaking. Experience will tell him whether the arrangement of stock is such that a good count is possible or probable. If the arrangement is extremely poor, he should ask that certain sections or the entire inventory be rearranged.

(b) Proper identification and description. The auditor should inspect some items of the stock, ascertain the source of the description, see that proper differentiation is made for the various stages of work in process, and check his findings with production personnel. Conflicting answers to his questions will cause doubt as to whether the client's employees who are taking the inventory are actually familiar with it.

(c) Segregation or proper notation of slow-moving, obsolete, or damaged goods. Frequently such items can be recognized by the auditor, or his inquiries may reveal their existence; if these items are not being properly noted, the auditor will naturally have reservations as to the inventory. One of the most effective ways of discovering the presence of such items is through review of perpetual or other inventory records.

(d) Control, preferably numerical, of the tags or count sheets. The auditor should ascertain that each inventory count team is charged with a certain sequence of tags and that each team is required to turn in those unused or spoiled. He should ascertain that some employee accounts for all tags at the completion of the inventory.

(e) Practices to be followed in the verification of individual counts. The auditor should watch some of the counts, noting whether the quantities and description are being carefully entered on the tags. The auditor usually should make a certain number of counts of his own, including some items of substantial value; in the event that differences between the limited test counts which the auditor makes and the counts by his client's employees indicate laxness, the auditor should insist upon recounts of the entire section in which the unsatisfactory condition exists. It is not reasonable to expect that substantial numbers of original cartons or packages be broken open or that an unreasonable amount of inspection be made of items not easily accessible, but when the auditor suspects that the inventory is not well taken he should take all steps which he believes necessary.

(f) Practices to be followed in obtaining a proper cut-off of receipts and shipments. At the time of inventory-taking the auditor may visit the receiving and shipping departments, noting the last receiving and shipping numbers, and seeing that each department is cognizant that no receipts after and no shipments before the cut-off should be included in inventory. It is frequently a desirable practice for receiving and shipping departments to earmark materials which should not be included in the inventory with some such notation as "not to be taken in inventory." The auditor can usually make a subsequent check of the records of each department after the inventory. Manufacturing operations should be suspended for the physical inventory, but if they are not, unusual care must be taken to control the movement of inventory, as it is frequently difficult, if not impossible, to get a good inventory under such circumstances.

The auditor will make notations of his counts of certain items to be investigated further and of other data to be used when he receives the finished inventory records. He may require duplicate inventory

tag stubs or sheets, which he will receive during or at completion of the inventory and of which he will retain control and check to the physical inventory records, in order to be sure that the quantities in the inventory are those recorded as counted. If he does not receive duplicate count records, he may note items from the original counts to be checked to inventory summaries. In his review of internal control the auditor will ascertain the procedures governing inventories on the premises belonging to others, such as consignments in, bailments, goods on approval, and goods held for repair; when the physical inventory is being taken, the auditor should ascertain whether these items are properly identified, that employees are aware of the nature of the items, and that they are properly recorded as the property of others. The auditor can later make such tests of accounting or other records as will give him further assurance that the property of others is properly recorded.

Inventories Taken Periodically Throughout the Year.—The auditor's observation of periodic counts is largely directed towards ascertaining whether the methods are good. He should observe the group making the counts, and follow as many of the audit procedures, outlined above for inventories taken at one time, as are practicable. He should consider whether the procedures followed in taking the counts conform to those outlined previously under the section on internal control, and review the differences between counts and perpetual records. Absence of substantial differences over a period of time and of difficulties in cut-off of receipts, shipments, and transfers between departments; knowledge that counts are carefully made by experienced employees; correspondence of records with physical arrangement of stock; and reasonable identification of stock without physical rearrangement; all are factors which may entitle the auditor to believe that perpetual records may properly reflect inventory quantities.

Alternative Procedures When Observation of Physical Inventories Is Not Practicable or Reasonable.—If no physical inventory can be taken by the client or if the auditor cannot be present at the inventory-taking, alternative procedures must be used to determine the reasonableness of inventory quantities.

During the recent war many contractors were operating their factories around the clock, seven days a week; the government did not permit interruption of production by a shut-down for inventory purposes. Frequently perpetual records either were not maintained or, if maintained, were not satisfactory by reason of extraordinary

volume, inefficient employees, or because physical arrangement of the inventory was not related to the records. Physical counts of work in process may be useless if adequate cost records are not maintained. The physical condition or nature of the inventories may make it difficult or impossible to relate physical quantities to dollars, for example when ores of differing metal content are stored in large piles. The auditor may be engaged to examine the financial statements of his client after the physical inventory has been taken. In these circumstances the auditor frequently applies alternative procedures which fall into two basic categories:

1. The establishment of other physical evidence which may be tantamount to physical observation.
2. The establishment of the validity of the inventories through further examination of the accounting evidence.

If physical inventories have been taken in the auditor's absence, he can frequently make physical tests subsequently, as a satisfactory substitute for observation of the inventory-taking.

A ship under construction is an example of an inventory which cannot be taken or priced in the usual way. The auditor may observe that a partly completed ship is on the ways. The records show costs of material, labor, and overhead, but these costs may not be readily comparable with the physical evidence. However, from engineers and production employees the auditor can ascertain that the ship is in a certain stage of completion, and by applying the percentage of completion to the estimated total cost he has a figure which should compare approximately with book cost. Such procedures may be tantamount to observation of a physical inventory by the auditor. Frequently other kinds of work in process inventory cannot be taken in the customary way, but it may be possible for the auditor to exercise his ingenuity in discovering a reasonable substitute. Quantity records may be maintained for labor bonus purposes and these may be priced and extended and the total compared with the control account; records of finished production may be examined after the inventory date and quantities produced may be observed. These procedures may offer a satisfactory basis for an opinion and may be equivalent to observation of a physical inventory.

If, through his examination of the accounts and the system of internal control, the auditor is satisfied that inventories are fairly stated, he may express this opinion, disclosing, however, that the taking of the physical inventory was not observed. On the other hand, there may be no practicable substitute for observation of inventory-taking.

Employment of Appraisers.—Sometimes the auditor considers that his observation of physical inventories is of such limited value under the circumstances that he may suggest calling in an independent appraiser to determine, for example, the value of an inventory of precious stones.

Examination of the Physical Inventory Records.—Some time necessarily will elapse between taking and summarizing the inventory. Usually the client will make his own investigation of inventory differences, although the auditor may wish to do so concurrently; satisfactory explanations of differences between book and physical inventory may be the most important part of his examination. In testing quantities and pricing of inventory summaries, the auditor will be guided by the evidence as to whether the client has already made careful and competent checks thereof; the fact that employees have indicated by their initials that certain steps have been taken is assuring but it is of even greater assurance to find as the result of test checks that the work is accurate. The authors have previously commented briefly on the use of accounting machines; in examining inventories compiled by machines, the auditor should not assume that their mechanical accuracy is necessarily any greater than that of those compiled by hand. It is true that errors committed by the machines themselves may be rare, but they do occur, and errors are sometimes committed by the operators of the machines. Usually the auditor will concentrate on larger items, scanning certain footings and extensions and exactly checking others. The auditor should determine that items included in, and excluded from, inventories are properly treated and that inventories are valued in accordance with generally accepted accounting principles consistently observed.

Quantities.

1. The auditor should make such tests as will give him reasonable assurance that only tags used for the physical counts are included in the physical inventory summaries.

2. The auditor should check his record of counts and test-check original count sheets or tags to inventory summaries; conversions and summarizations of units should also be checked.

3. If perpetual records are maintained, the auditor should test-check quantities thereto and review differences.

4. Quantities should be compared with those in previous inventories on a test basis; this comparison may indicate some slow-moving items.

5. Perpetual or other records should be reviewed for further indications of slow-moving items.

6. The auditor should test the observance of cut-off and the inclusion of in-transit items.

7. Stock held by others, such as in public warehouses, on consignment, or in hands of processors, should be substantiated by direct confirmation in writing from the custodians; in addition, it may be desirable, because of the size of the inventory or because the confirmation is not satisfactory, to take a physical inventory of the stock. The confirmation may be unsatisfactory if the holder is not considered responsible in relation to the amount of the inventory which he holds, or the holder may, as public warehouses customarily do, only confirm that he has possession of certain packages bearing a description of the contents but without representation as to the contents. While negotiable warehouse receipts are usually trustworthy, withdrawals are not always noted on these receipts, and it is often advisable to request direct confirmation by letter.

Pricing.

1. The auditor will have reviewed and tested the client's cost system in connection with his review of internal control and analyses of inventory accounts. He should make sufficient tests to determine that costs to be applied to inventories are fair and in accordance with generally accepted accounting principles. In examining an inventory of purchased items these tests will include reference to current invoices or purchase contracts.

2. The auditor should test-check the application of prices to inventory quantities, extensions, footings, and summarizations.

3. Pricing of obsolete, slow-moving, and damaged stock should be reviewed to determine that it is not in excess of net realizable amount.

4. The auditor should review and test the determination of market prices. Tests similar to the following should be made to determine whether market is lower than cost.

Current selling prices less cost of disposition of individual or major groups of products should be related to inventory prices. As previously stated, Accounting Research Bulletin No. 29 indicates that inventories, when priced at market, should not be stated at less than net realizable value reduced by an allowance for an approximately normal profit margin. Consequently, the auditor need not determine the amount of inventory at reproduction or replacement costs when there is acceptable evidence that individual or groups of

items, priced at cost, will be sold at prices which will yield normal profit margins. Such evidence will best consist of current and expected selling prices and sales orders, as related to current costs.

The relation of outstanding sales contracts to raw material purchase contracts should be investigated. In some businesses it is possible that low-cost material purchased to cover long-term sales contracts (taken at corresponding prices) may in effect have been used to fill high-priced sales contracts taken for immediate delivery. The result is that when the higher priced raw materials (purchased to cover the high-priced sales contracts) are received, they will be used to fill low-priced contracts, possibly at a loss.

Replacement costs are usually test-checked by reference to cost records, current invoices, or purchase contracts. Reproduction costs are normally substantiated by cost records supplemented by conferences with production and accounting employees.

Special Considerations as to Work in Process.—The examination of work in process inventories frequently involves the auditor in problems which tax his ingenuity.

As indicated previously there sometimes is difficulty in identifying work in process with the accounting records, even though a complete inventory is taken at one time. This difficulty is most pronounced when (1) the physical nature of the work in process is such that it is difficult to identify it, such as when it does not take on the aspects of the finished product until or shortly prior to completion, or (2) good process costs are not maintained, whether because the product is manufactured on a custom basis and costs vary from lot to lot, or simply because of a poor cost system. There is no set formula to prescribe in such instances and the auditor must relate the physical evidence to the records in whatever is the most appropriate way, or rely upon comprehensive tests of the accounting records.

Furthermore, work in process inventories may not be taken physically or they may be taken physically at some time other than that at which raw materials and finished stock are taken, or they may be taken at one time and the balance of the inventory may be taken on a cycle basis throughout the year. Under these circumstances the auditor should take particular care to ascertain that, through the internal control or through tests of transactions, proper credits to work in process are made both for production transferred to finished stock and for shipments directly from work in process to customers, since unrecorded transfers may result in an overstatement of the inventory. Unless the controls over the relief of work in process are

good, the auditor should preferably insist that the entire inventory be taken at one time or else undertake comprehensive tests of the records, which tests may or may not give satisfactory results; in such tests the auditor may be well advised to refer not only to the conventional accounting records but to such records as those of the production control or other departments which may record the physical movement of inventories.

General Considerations and Over-all Tests.—The auditor may lose his perspective in the application of various detailed tests and later he should review the inventory as a whole. He should beware of any increase in inventories without a corresponding increase in sales, or of a lower turnover which may indicate overproduction or sales resistance on the part of customers. He may be well advised to analyze differences in the rate of gross profit between the current and past years, since discrepancies therein are sometimes the result of errors in inventories. Occasionally purchase or production records in terms of units can be correlated with opening inventories, sales, and closing inventories; major discrepancies in this correlation should be investigated.

Purchase Commitments.—As set forth in the first part of this chapter, the practice of providing for losses on purchase commitments is now generally recognized. These losses should be provided for on the same basis as inventory losses. The auditor should review the record of purchase commitments and relate them to inventories and to expected sales. For example, if purchase commitments have been made at prices in excess of current market prices, but nevertheless a normal margin of profit seems assured from the sale of the finished article, no provision for loss will be necessary. If, on the other hand, there are substantial purchase commitments and the inventory is priced in excess of market, or is excessive, consideration should be given to possible loss on purchase commitments. Purchase commitments are of two kinds: (1) commitments with suppliers for materials to be used in the ordinary course of business, and (2) futures contracts for the purchase or sale of commodities under which delivery usually is not made and which sometimes represent a hedge and sometimes a speculation.

Inventory Certificate.—This certificate confirms statements made by the client as to the method of taking inventory, the ownership of the inventory, and the basis of its valuation, and avoids misunderstandings as to these matters between the auditor and the client. In

addition, it reminds the client that the primary responsibility for inventories rests with him rather than with the auditor. The request for such a certificate is a customary procedure and in no way reflects upon the integrity of the client. In initial engagements it is desirable to obtain a similar certificate covering inventories at the beginning of the period. The status of purchase commitments may be covered in this certificate or in the liability certificate discussed in Chapter 16. The inventory certificate may be similar to the following form, with variations appropriate to the circumstances:

INVENTORY CERTIFICATE

Name and Address of Auditor

Dear Sirs:

In connection with your examination of the balance sheet of .... as at .... I hereby certify that the inventory at that date, of which the following is a summary,

....	$........................
....	....
....	....
	$________

was taken under my direction, and that to the best of my knowledge and belief:

1. The quantities are correct and were determined by actual count, weight or measurement as at .... (if a physical inventory was not taken at one time, substitute a statement as to the adequacy of the perpetual inventory system and statements as to the frequency and coverage of physical tests and the agreement of the quantities and amounts so determined with the perpetual inventory book record);
2. The entire inventory is the unencumbered property of the company, has not been pledged as collateral, and includes no items billed by the company up to and including the balance sheet date nor any items held on consignment;
3. Each item or specified group of items of the inventory is priced at cost or market, whichever is lower, and not in excess of net realizable value;
4. The basis of pricing and method of computation is the same as was used at the end of the previous fiscal period. The general basis on which cost is determined is as follows (as first-in, first-out; average; last-in, first-out; etc.);

5. No obsolete, slow-moving, damaged or unusable materials or merchandise are included in the inventory at prices in excess of net realizable value;
6. The amount stated above is a fair and proper valuation of the inventory for inclusion in the balance sheet at ....

Very truly yours,

Date signed ....

Time of Examination.—Physical inventories are often taken at some date before that of the balance sheet; sometimes, the inventory is taken during the vacation period of factory employees. This permits the more prompt issuance of financial statements and relieves pressure on the auditor at the year end. This practice is permissible only when such records exist as will provide reasonable assurance that the interim transactions are properly recorded and permit the auditor to make a reasonable review thereof. Thus, the bulk of the auditor's examination of inventories may take place at some time prior to the balance sheet date.

Coordination of Examination with That of Related Accounts.—The auditor's examination of inventories is closely related to his examination of cost of sales; a satisfactory determination of inventories is, in many cases, more important than anything else to producing a fair statement of income. The review, analyses, and tests of cost of production and of the flow of cost of production into cost of sales usually are accomplished in large measure when the auditor has completed his examination of inventories. The auditor will usually trace charges to overhead for such items as depreciation and taxes to the related reserve or accrued liability accounts.

When quantities or units in opening and closing inventories can be reconciled with production and sales, it is sometimes possible to obtain a proof of the sales account by extension of quantities sold at selling prices.

STATEMENT PRESENTATION

Introduction.—Inventories, to the extent current, are carried in the current asset section of the balance sheet, usually following accounts receivable. Since the determination of inventories requires the exercise of judgment, and since the differences between various methods of valuing inventories may be great, it is important that the basis of valuation of inventories be adequately described.

Disclosure of Components.—It may or may not be significant to disclose the amounts of raw materials, supplies, work in process and finished stock as required in financial statements to be filed with the Securities and Exchange Commission. If the relative investment in the different categories is normal, no useful purpose may be served by a breakdown. On the other hand, if there is an abnormally large investment in one category, such as a large amount of finished stock which may indicate an unhealthy sales situation, it may be important to disclose its amount. When there is no disclosure of the amounts of the components of inventories, it is frequently the practice to state them in some such caption as "Inventories of raw materials, supplies, work in process, and finished stock" if all such components are represented.

When progress payments under long-term contracts have been deducted from inventories, it is frequently the practice to disclose the amount of these payments; thus the combination of the two figures, the net inventory and the progress payments, indicates the gross amount of the physical assets on hand.

When materials included in the inventory are to be used, to an indeterminate extent, for either construction or maintenance or for a product which may either be sold or leased, it is appropriate to disclose this fact.

Disclosure of Basis of Valuation.—A brief description of the basis of inventory valuation should be made in the balance sheet, together with further disclosure of any unusual aspects. Thus, the statement that inventories are at "the lower of cost or market" may be sufficient when cost is reasonably close to current cost, but when it is not, as under Lifo, the method of determining cost should be disclosed. While the methods of determining cost and market are required to be disclosed in financial statements filed with the Securities and Exchange Commission, it is not considered necessary to make such disclosure in all financial statements, unless it be helpful and informative.

The use of the base stock method should also be disclosed since here again the inventories are usually carried at an amount well below current cost or value. Some companies disclose basic quantities and prices or provide a reserve against the inventory to reduce it to a valuation under the base stock method and disclose the amount of this reserve.

Reserves.—When inventories are reduced to a generally accepted basis by reserves, these reserves should be deducted from the inven-

tory and may or may not be disclosed, depending upon their significance. Disclosure may be appropriate of a reserve under the base stock method discussed above, or of a substantial reserve based on estimate or judgment rather than on exact calculation, such as a reserve for reduction of a relatively large contract in process to estimated net realizable value.

When reserves are provided for other purposes they should not be deducted from inventories, but should be shown as appropriated surplus or in the reserve section of the balance sheet. Many companies have recently provided such reserves, for example, for future decline in inventory prices.

Disclosure of Liens and Encumbrances.—Borrowings accompanied by a pledge or other encumbrance upon the inventory should be stated as a liability and the amount of the inventory which is pledged should be revealed. As a rule, borrowings should never be shown as a deduction from inventories. Examples of these borrowings are bank loans, advances by factors, by finance companies, or by customers. The retention of protective title by lenders should be disclosed.

Disclosure of Adjustments in the Statement of Income.—The reduction of inventories and commitments to market may result in a charge to income so large that the reader of the income statement receives a distorted impression of the results of operations if disclosure is not made; if so, the preferable method of disclosure is a segregation of these charges from cost of sales. On the other hand, inventory charge-offs are normally recurring in some businesses; when their segregation may convey the erroneous impression that these losses are nonrecurring it is usually better not to disclose them.

Lack of Consistency or Comparability.—Consistency in inventory methods is of great importance, particularly to the determination of income. Disclosure should be made, preferably in a note to financial statements, of any material change in principle or in the application of a principle during the accounting period which renders the financial statements inconsistent with those of the previous period and materially affects the comparability of the financial statements with those of the previous period. Disclosure should include the dollar effect when practicable. It may also be appropriate to disclose a change which will have a material effect upon future statements although its effect upon the current statements is not material.

CHAPTER 12

PROPERTY, PLANT AND EQUIPMENT

Investment in property, plant and equipment represents a substantial portion of the total assets of many companies. The purpose of the auditor's examination of asset accounts representing property, plant and equipment is to inform him of the basis on which they are stated—at cost, or at amounts which may be higher or lower than cost—and to determine whether the policies followed in recording additions to and reductions of the fixed assets accounts are in accordance with generally accepted accounting principles consistently applied.

ACCOUNTING PRINCIPLES

General Principles.

Basis of Inclusion.—The term "property, plant and equipment" includes all tangible assets which (1) are to be used in the conduct of business, (2) are not intended to be sold in the ordinary course of business, and (3) have a service life in excess of one year. It includes such assets as:

(a) Property ordinarily subject to neither depreciation nor depletion, such as land used for industrial or commercial purposes.
(b) Property subject to depreciation, such as buildings, machinery and equipment, and large tools.
(c) Property subject to depletion, such as mines, oil wells, and timber.

The propriety of the book amounts for property, plant and equipment of a going concern depends not only upon the accounting for the initial acquisition, but also upon the policy followed with respect to subsequent additions, replacements, retirements, and repairs. The policy adopted should be in conformity with generally accepted accounting principles, and consistently followed.

Basis of Stating Property, Plant and Equipment.—The property, plant and equipment of enterprises which are continuing in business and in which a forced sale or liquidation is not contemplated as a general rule should be carried at cost less an adequate allowance for depreciation due to wear and tear and obsolescence. Wasting

assets, such as mines, generally should be carried at cost less an allowance for depletion. Accounting Research Bulletin No. 5, issued in April, 1940, states:

> Accounting for fixed assets should normally be based on cost, and any attempt to make property accounts in general reflect current values is both impractical and inexpedient. Appreciation normally should not be reflected on the books of account of corporations.

It is generally accepted accounting practice to maintain this basis even in periods of rising prices such as followed World War II. Accounting Research Bulletin No. 33, issued in December, 1947, states in part:

> The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels.

This position was reaffirmed in a letter addressed to members of the American Institute of Accountants on October 14, 1948, by the Committee on Accounting Procedure.

While cost is the accepted basis of recording property, plant and equipment, other bases of valuation are used in practice, and at times may be justified. The auditor should therefore understand the principles underlying the use of other bases, and be qualified to form an opinion regarding any procedures used in the valuation of property accounts.

Unusual circumstances such as a reorganization or quasi-reorganization of a company may justify a revision of the carrying amounts. A general appraisal of property, plant and equipment may show substantial changes in replacement or useful costs, and may lead to a restatement of the originally recorded amounts. In the authors' opinion, if circumstances warrant a restatement of property, plant and equipment, such major revision of reported plant assets is tantamount to a quasi-reorganization requiring such adjustment or restatement of other assets as would be called for by a quasi-reorganization; subsequent financial statements should show surplus at the date of the appraisal as paid-in surplus, surplus from revaluation of fixed assets, etc. Earnings credited to earned surplus accumulated from the date of such quasi-reorganization should be credited to a new and dated earned surplus. To date, however, the Committee on Accounting Procedure of the American Institute of Accountants has not expressed itself as to whether it considers the recording of an appraisal of fixed assets, without a similar adjust-

ment of other asset and liability amounts, as sufficient grounds to apply the rules pertaining to quasi-reorganizations.

When property is acquired for capital stock which has no readily determinable value, an appraisal of the property acquired may be helpful in establishing the amount for which the capital stock is issued. Appraisals also serve a useful purpose in the allocation to tangible or intangible property of the excess of cost of an investment in a subsidiary over its recorded net assets at date of acquisition.

Value in Relation to Cost.—The term "value" has been the subject of wide discussion throughout the years. It has been subject to many interpretations and modifications, such as "value in use," "value in exchange," "liquidation value," "quoted value," "fair market value," "appraisal value," "book value," and many others.

In the abstract, the term has been defined as the attributed worth of anything expressed in money. Without qualification, the term has little significance. With respect to the term "value," Accounting Research Bulletin No. 9, issued in May, 1941, states:

> "Value" as used in accounts signifies the amount at which an item is stated, in accordance with the accounting rules or principles relating to that item. Generally book or balance-sheet values (using the word "value" in this sense) represent cost to the accounting unit or some modification thereof; but sometimes they are determined in other ways, as for instance on the basis of market values or cost of replacement, in which cases the basis should be indicated in financial statements.

It is clear that the term "value" should be used with great caution and only when there can be no misunderstanding with respect to its meaning upon the occasion of its use. Furthermore, it should be properly qualified.

The term "book value" is really a misnomer, but is so widely used that recognition of it can hardly be avoided. As applied to property, plant and equipment, it refers to the amount, usually cost (in either cash, other property, securities issued by the owning corporation, or a combination thereof) less accumulated depreciation, at which such assets appear in the books.

Especially in times of varying prices, "cost" and "value" should not be used interchangeably. The accountant customarily uses cost, even when present-day economic values differ widely from cost.

Depreciated cost is an historical record rather than a measure of present-day value. The value of an asset to a going concern is measured solely by its value in use. It may be that the cost was justified, or that either a bargain purchase or an extravagant purchase was made.

Components of Cost.

Includible Components.—The cost of property, plant and equipment includes all expenditures necessary to make property usable by the concern on whose balance sheet it is reflected. In addition to invoice or contract prices, outlays for transportation and for installation, and, in some instances, expenditures necessary to establish title, are proper elements of cost.

Certain regulatory commissions, such as the Federal Power Commission, prescribe uniform systems of accounts wherein detailed classifications of property, plant and equipment are provided. Cost is prescribed as a basis for charges to these accounts, but as discussed elsewhere in this chapter, cost, as defined by such regulatory bodies, is original cost, that is, cost to the person first devoting it to public service. For enterprises other than certain public utilities, cost means cost of acquisition to the present owners.

Cash Discounts.—It is generally accepted as good practice to consider cash discounts, deducted from payments for property, plant and equipment, as savings and not income, and to treat the net amount paid as the cost of the assets acquired.

In practice, however, many companies consider the total amount of cash discounts as insignificant and make no distinction between cash discounts on purchases of property, plant and equipment and cash discounts on purchases of material and supplies, and when the amount involved is not material, this treatment is acceptable.

Interest During Construction.—Cost may include interest paid during the construction period on borrowed money used for construction purposes. Otherwise a concern might incur a deficit with respect to a new plant before its completion. After completion a plant is expected to earn sufficient profit to cover interest, but it is unreasonable to apply this rule before its earning power exists.

Outside of the public utility industry few companies follow the practice of charging interest on construction. In the public utility industry, however, it is general practice. The Federal Power Commission's Uniform System of Accounts prescribed for Public Utilities and Licensees, which is typical of other uniform systems prescribed by similar regulatory authorities, specifically provides for the inclusion of interest during construction, which is defined as ". . . . the net cost of borrowed funds used for construction purposes and a reasonable rate upon the utility's own funds when so used." Various interpretations of this definition have led to a wide variety of practices. Some utilities, as a matter of conservatism, do not

capitalize any interest during construction. Others capitalize interest only on important projects, or on projects involving certain minimum expenditures varying from $100 to $500,000. Some capitalize interest on borrowed capital only. Others capitalize interest on both borrowed capital and equity capital. Some utilities base the rate of interest on the cost of money used; others may use the dividend rate on preferred stock if issued to provide for plant expansion.

The use of a rate higher than that currently expended on borrowed or equity capital, used to finance construction, does not appear justified, because it usually represents a capitalization of theoretical profits or earning power, which is generally undesirable.

There is general agreement that the period for which interest should be capitalized runs from the actual beginning of construction work to the beginning of operation or the date when the property is placed in service. In large companies with considerable construction activity, transfers of completed work are usually made monthly from the construction in progress account to the appropriate plant accounts. Care should be taken to see that capitalization of interest stops as soon as new units are ready for service.

When income bonds are outstanding during construction periods and it is believed that the interest will be paid for those periods, it is proper to accrue and capitalize the interest, even though its payment depends on sufficient income to pay the interest and the authorization of the payments by the directors.

Overhead When Concern Erects Buildings or Manufactures Its Own Equipment.—When a manufacturing concern erects some of its own buildings or manufactures some of its equipment, there arises the question of the amount of overhead which can properly be included in the costs of such buildings and equipment. The best procedure is to add to plant asset accounts only the overhead that can be attributed directly to the work done on the plant or equipment. In any event, the overhead added should not increase the cost to a figure higher than that at which the article can be purchased in the market.

If a concern manufactures its own equipment or erects a building and does it for less than it would cost if done by outsiders, good accounting practice does not permit an increase in cost of the asset and a credit to income equal to the assumed saving. The very good rule that one cannot make a profit out of dealing with himself should be invoked. The benefit of the saving, if any, is realized through lower depreciation charges.

Most large companies have regular maintenance departments which handle improvements and new construction as well as repair jobs. It is usually the practice to consider the supervisory and indirect expenses of this department as overhead, and to distribute these costs over the jobs performed. These overhead costs should include those of the maintenance department only, and ordinarily should not include general expenses of the company or overhead costs of operating departments. Some services may be performed for the maintenance departments by other service departments such as those for purchasing or accounting, but the costs of these services are usually negligible.

Property, Plant and Equipment Accounts—Additions to.

Land and Land Rights.—*Includible Costs.*—Costs of filling and draining, commissions to agents, and other costs directly attributable to the acquisition of property and to conditioning it for use, should be included in the asset amount. As a matter of general practice, the originally recorded cost should not be written up, although it may be clear that its value has increased. Similarly, if land has apparently depreciated in value, it may be carried at cost until realization of the loss.

Carrying Charges on Undeveloped Property.—When unimproved property is held for development or sale, taxes and other carrying charges may or may not be added to the cost. In either case the auditor should insist that the facts be disclosed.

When undeveloped property is carried as an investment and its development is deferred solely as a part of a well-defined plan and not because it would be unprofitable, a reasonable amount of carrying charges may be capitalized. When there is a possibility that undeveloped property may be disposed of at a loss, discretion must be used in capitalizing such expenditures. It is not good accounting practice to continue the capitalization of carrying charges to a point beyond the reasonable valuation of the property. On the other hand, while it may be expedient or conservative to charge off expenditures which do not add to the value of assets, it may not be good accounting practice to do so, as it may unduly reduce the profits arising from current operations and understate the fair cost of the asset. When unimproved property finally is developed, subsequent operations should absorb the entire cost of the property.

Other Costs Incurred During Development Period.—Most costs and expenses up to the time when property is ready to be marketed

usually can be charged against the property. Such costs and expenses may include the grading and paving of streets and the cost of water and sewer installations. Administrative expenses and preliminary selling expenses, such as advance advertising, publicity work, printing, and the preparation of maps, if not charged off, should be segregated and shown on the balance sheet as deferred expenses.

When development work is completed and the property is to be sold by lots, it is good accounting practice to apportion the total cost among the salable lots, in order that there may be a measure of gain or loss on each parcel sold, rather than to apply all proceeds to the total cost until the entire investment is recovered. Such apportionment of cost is in accordance with the regulations of the U. S. Treasury Department [Regulations 111, Section 29.22(a)-11]. An approved method of apportionment is to place a selling price on each lot, and to allocate the total cost to each lot in the relation of its sales price to the total sales price.

Special Assessments.—Assessments tending to increase the value of property, such as street, sidewalk, and sewer district assessments, should be capitalized. Assessments used to finance transitory services, such as lighting, sprinkling, and cleaning streets, snow removal, and protection of trees, where the benefit is temporary, should be charged to expense. Assessments for transitory services may recur annually and no permanent benefit arises therefrom.

It is usually permissible to pay special assessments in installments. When the client takes advantage of this opportunity, the entire amount of the assessment, not merely the amount of installments paid, should be recorded and the unpaid portion should appear among the liabilities. Interest, if any, on deferred payments should be treated as an expense.

Expenditures to Establish or Defend Title.—Attorneys' fees and all other expenditures in investigations and litigation to establish clear title to property may be capitalized. However, the extent to which such expenses should be added to cost is limited by what is considered a fair valuation of the property in question.

Allocation of Cost of Demolished Buildings.—When land and buildings are purchased with the intention of demolishing the buildings, the original cost, plus cost of (or less salvage from) the demolition of the buildings, represents the cost of the land. When the intention to demolish is formed subsequent to purchase, the cost of demolition plus the cost allocated to the buildings at time of purchase

may represent a realized loss or an additional cost of land, according to circumstances. When the demolition follows the discovery of unexpected defects in useful value, the entire cost of removal of the buildings and the original cost should be charged to expense.

BUILDING.—*Includible Costs.*—It is permissible to capitalize expenditures not only for direct costs of building construction, but also for such items as permits, architects' and engineers' fees, interest on borrowed money, and legal fees. Overhead expense directly applicable to construction work may also be included.

The costs of service equipment such as the heating system, plumbing system, electrical wiring and fixtures, elevators, and other improvements usually are included in the building account, although some companies prefer to record them in separate asset accounts so that varying rates of depreciation may be applied to the respective items.

MACHINERY AND EQUIPMENT.—*Includible Costs.*—The cost of machinery and equipment which should be capitalized includes not only the cost of acquisition but also the cost of installation, including freight, labor, and other items, which are as much a part of the cost as the price of the machinery itself.

Costs of large tools such as lathes, looms, and motors, are usually included under this classification, but costs of small tools such as shovels, hammers, and saws are not. Small tools are usually carried as supplies. They are discussed on page 230.

Development Expenditures.—Many industrial concerns maintain machine shops for the construction of some part or all of the equipment needed in the business. In constructing new models of machinery, the cost of the first machines produced generally exceeds the cost of those subsequently manufactured because of necessary development expenditures. Normally, it is proper to capitalize a reasonable amount of these development expenses which may be allocated to the cost of additional machines to be constructed within a reasonable period. On the other hand, excess costs arising from costly errors in construction should not be included in the cost of construction. Generally expenditures incurred after the machines have been placed in operation, including expenditures for tests, correction, or improvement in installation, should be considered as expenses and not as an addition to the cost of the equipment.

Purchases on Deferred Payments.—When machinery is purchased on the partial payment or installment plan, only the cash

purchase price should be charged to the machinery account. The gross purchase price should be credited to the vendor, and the excess of that price over the cash price, representing a charge for the delayed payments, should be charged to the interest account at once or thereafter over the period of the installment payments if the amount of the excess warrants such deferment.

Purchases Under Royalty Agreements.—Machines are sometimes purchased under an agreement that royalties will be paid on units of production. These royalty payments are not costs of acquisition and should be charged to operating expenses as they constitute payments in addition to the purchase price of the machine. The cost of the machines should be recorded as an asset and depreciated on the basis of the useful life of the machines. When machines are installed under contracts whereby so-called royalties or rentals may be applied against their purchase price, the machines should be accorded the same treatment on the books as if they were being definitely purchased on a deferred payment basis, provided, of course, there is every intention of purchasing them.

Automotive Equipment.—Cost of the equipment charged to the account should include the first cost of all accessories. Replacements of accessories, however, should be charged to expense. Classification of this equipment as to function, such as production, sales, or administrative, facilitates the allocation of depreciation to the proper expense account.

Furniture, Fixtures, and Small Tools.—Furniture and fixtures have little residual value. In years past large companies often did not capitalize expenditures for these items, and conservative companies still do not capitalize small expenditures for them. However, most companies today carry furniture and fixtures in asset accounts.

In these accounts will be found charges for the purchase and erection of partitions, special shelving, desks, chairs, and other office equipment. Items of this nature used for factory purposes may be included with machinery and equipment, or separate control accounts may be provided for them, to facilitate the allocation of depreciation thereon.

So many hand and other portable small tools are worn out, lost, or stolen that it is often impracticable to treat them as property, plant and equipment, and write them off through depreciation charges. Some companies follow a method under which tools are inventoried periodically and the accounts adjusted accordingly. A more desirable

method is to treat small tools as supplies inventory, and to charge them to expense when they are put into use. Under this method only new tools which have not been placed in service are considered as an asset.

Returnable Containers.—Returnable containers include steel drums, barrels, kegs, boxes, cartons, bottles, syphons, and other types of containers, which in many lines of business are necessary for the shipment of the company's product and which the customer is obligated to return. To provide an incentive for their return, a charge is usually made, frequently in an amount in excess of the cost of the container. The charge is ordinarily settled by credit arising when the container is returned, but sometimes cash is collected, in lieu of return of the container.

With Life of More Than One Year.—Containers of substantial construction, such as steel drums and reels for heavy wire or cable, have service lives of several years and usually are included among fixed assets. Their cost is written off through periodic charges for depreciation. Because their cost is relatively high, deposit or memorandum charges may be substantial and they usually induce reasonably prompt return by the customers. Returnable containers are frequently carried in two accounts, one for containers on hand, and the other for containers in hands of customers.

With Life of Less Than One Year.—Smaller, more fragile and less valuable containers, such as carboys, generally have service lives of less than one year and are carried as supply inventories. Losses because of breakage or failure to return may be charged off currently on a basis indicated by experience and checked by annual or periodic inventory. If the quantity of unused or returned containers on hand exceeds one year's normal requirement, the excess should be classified as a noncurrent asset. These containers may be charged to expense when put into use and charges to customers and related liabilities kept in memoranda accounts.

Improvements.—The fact that practically no part of a plant is renewed or replaced in exactly its former state, but almost invariably is enlarged or otherwise changed for the better, makes it difficult to determine the amount to be capitalized. If earning capacity is not increased, there is a presumption that no part of the new cost should be capitalized, but there is no rule that can be followed in all cases.

The difficulty in determining the amount to be capitalized may be solved by adopting the preferred accounting procedure of charging

the cost of the improvement to the plant account and crediting that account with the original cost of plant retired. Such procedure, however, sometimes raises the equally difficult question of determining the cost of the plant displaced.

Cost of Alterations.—A company may be justified in capitalizing the major part of the cost of alterations which result in increased capacity or reduction in expenses. When the alterations merely modernize buildings or equipment, and do not increase the rate of output, there may be no actual improvement in property which will be of benefit in the future. When allowance for depreciation contains, as it should, adequate allowance for obsolescence, all or part of the cost of alterations may be charged against the accumulated allowance for depreciation.

Cost of Rehabilitation.—Rehabilitation implies something more than ordinary repairs. It implies a complete overhauling and reconditioning, which may not result in expanded capacity of a facility, but which will materially extend its useful life and assure its continued productivity. Under these circumstances, because it may be difficult or impossible to identify the cost of items removed, a charge to the allowance for depreciation of a part of the total cost of rehabilitation may be acceptable instead of the separate removal from plant accounts of the original cost of items displaced.

Reconditioning of Newly Acquired Plant.—When partly worn-out or run-down plants are purchased with the intention on the part of the new owners to rehabilitate them, so that they can be operated efficiently, it may be assumed that the purchase price takes into consideration the poor condition of the plant. Under these circumstances the entire cost of repairs and renewals necessary to bring the plant to a satisfactory operating condition, including such overhead items as are applicable, may be capitalized.

Property Acquired for Consideration Other Than for Cash.—*Property Acquired in Trade.*—Occasionally property is acquired in exchange for other property. Often the property acquired is recorded at the carrying amount of the property disposed of, plus or minus any amount required to equalize the exchange. The practice is sound, provided that the carrying amount of the assets disposed of is reasonable and based upon accepted principles. If the asset disposed of is overstated or understated on the books by reason of inadequate or excessive allowances for depreciation, the recorded amount of the new asset should be adjusted accordingly. If the

acquired property has been appraised recently or has a readily obtainable market value, this value may be a guide to the valuation to be recorded and to the profit or loss, if any, resulting from the exchange.

Property Acquired in Exchange for Company's Capital Stock or Bonds.—As a general rule, cost should be determined either by the fair market value of the consideration given or by the fair market value of the property acquired, whichever is the more clearly evident.

When neither the fair market value of the property nor of the securities issued is readily determinable, the situation requires careful consideration. When bonds alone are issued, there may be a presumption that the principal amount of the bonds represents the purchase price, which may then be recorded as the cost of the property. However, the principal amount of the bonds alone may not be an adequate measure of value because other conditions relating to the bonds have a bearing on their value. For example, if 2 per cent bonds are issued at a time when similar corporations are issuing 5 per cent bonds, the presumption that the bonds are worth par is unreasonable, and an attempt should be made to establish fair market value.

When stock alone is issued, and no fair market value of stock is readily determinable, the par or stated value of the stock may or may not be a reasonable basis for recording the cost of the property acquired. Some appraisal of the property must be made, either by the management or by outside parties, taking into consideration all of the pertinent factors.

Property Acquired as a Contribution or Donation.—When property has been acquired through gift, or title is to be transferred by gift upon the fulfillment of certain conditions, the property should be appraised at the time it is taken over, but the valuation should not be included as an asset until all conditions are fulfilled.

PROPERTY ACQUIRED AS PART OF A PACKAGE.—There is now widespread recognition of the need for a careful breakdown of the total cost of a going concern when it is acquired for a lump sum. Assets acquired may be classified for accounting purposes by obtaining valuations of all tangible assets and, if these valuations, less liabilities assumed, are less than the purchase price, the balance may be considered to represent cost of intangibles. If the valuations, less liabilities assumed, are more than the purchase price, the difference may usually be deducted from the valuation obtained for fixed assets.

Property, Plant and Equipment Accounts—Retirements and Disposals.—When a company maintains detailed records of its property, plant and equipment, and computes depreciation on a unit life basis, the accepted accounting treatment of retirements is well defined. When plant units are retired from service, the cost should be credited to the property account, the accumulated depreciation should be charged to the allowance for depreciation, and the profit or loss, adjusted for salvage value and cost of removal and disposition, should be reflected in the appropriate income account.

When a company computes depreciation on a composite rate basis, as described in Chapter 13, the accepted accounting treatment is somewhat different. When plant units are retired from service, the cost should be credited to the property account, and such cost, plus cost of disposition and less salvage value, should be charged to the allowance for depreciation. No profit or loss is recorded on normal retirements, because the composite rate contemplates retirements of individual items before and after the expiration of the estimated average life. However, there are instances when unusual retirements may warrant recording profit or loss in the income account, even though composite rates of depreciation are used. An example is when all items of a certain type or class are retired because of a type of obsolescence not contemplated in setting the composite rate of depreciation. Another example may be when facilities for the production of a discontinued major line of product cannot be converted to other use and are retired. Composite rates of depreciation usually make no provision for such abnormal retirements.

Mines.—Practices peculiar to mining relate to exploration (work performed to determine if a mineralized area has commercial probabilities), development (work performed to prepare a mineralized area for commercial production), and treatment of plant and equipment acquired to maintain normal production.

Prior to beginning commercial operations, the costs of all exploratory and development work, less the proceeds of sales of production, are capitalized, usually under the general caption of "development." The rule of the Bureau of Internal Revenue as to when a mine has passed from the development to the producing status is generally accepted as reasonable. Such rule provides that the change has occurred "when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining."

Subsequent to beginning commercial production, the cost of development work is usually charged to expense because of the practical difficulty of separating development costs from operating costs. If it is clear that exploratory or development work is being performed on entirely new areas of the property, there can be no objection to capitalization of the cost.

As extraction proceeds shafts may become deeper and working faces recede with the result that more track, cars, and other equipment will be necessary to produce the same quantities as were produced at the beginning of operations. As in the case of the treatment of costs of exploration and development, the regulations of the Bureau of Internal Revenue with respect to such additional plant and equipment are generally considered reasonable. These regulations provide that "expenditures for equipment . . . . which are necessary to maintain the normal output solely because of the recession of the working faces of the mine, and which (1) do not increase the value of the mine, or (2) do not decrease the cost of production of mineral units, or (3) do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made, shall be deducted as ordinary and necessary business expenses."

In recognition of the fact that as extraction proceeds and workings become deeper and more extended more equipment will be necessary to maintain normal output, it has been suggested that the distortion of higher costs in the later years might be avoided by providing depreciation in the earlier years not only on the plant and equipment then owned but also on the plant and equipment estimated to be necessary to complete extraction of the mineral. While recognizing that such procedure requires forecasting of future equipment requirements and costs which might vary widely during various stages of the economic cycle, the authors nevertheless believe that if reasonably applied the principle is sound.

Oil and Gas Wells.—There are many unusual features in the accounts of concerns in the petroleum industry. A number of them relate to the amounts at which their investments in properties are carried.

In a typical case, a well is drilled by a contractor for an oil company which has executed a contract (oil or gas lease) with the owner of the land. Oil or gas leases usually provide for payment of a bonus, upon execution, to the lessor and for the payment annually of a stated amount per acre as rental, with stipulations as to development of the property by the oil company. Rental ceases when pro-

duction begins; the lessor thereafter receives a royalty, or share of the production, usually one-eighth in commercial leases and one-sixth in Indian Agency (Government) leases. Thus, in a commercial lease, the working interest or seven-eighths of the production accrues to the oil company.

The original or flush production of a well is no criterion of the later flow and no one can foretell accurately the commercially useful life of a well. However, based on experience and knowledge of oil and gas formations, geologists and petroleum engineers can estimate the amount of oil or gas, or both, recoverable from a well. These estimates are used generally as the bases for computing the amounts of depletion and depreciation sustained as a result of production.

An undeveloped lease sometimes is carried at the total of the bonus referred to, expenses incurred in obtaining the lease, and the cost of geological and geophysical work performed thereafter. This total cost is amortized over the life of the lease or, if production is obtained before the expiration of the lease, amortization is discontinued at the date of production and thereafter depletion is computed on the net remaining investment. Rentals are charged to expense as they accrue. An alternative method is to capitalize the bonus, rentals and other costs and expenses, carrying the lease at the aggregate of these amounts until relinquishment or development of production. Under this plan, if the lease is relinquished, the cost is written off. In the event of production, the investment is subject to depletion.

Development Expenditures.—Costs of drilling and equipping wells usually are capitalized. However, sometimes the so-called intangible costs are treated as expenses and the remainder is capitalized. Such intangible costs may be described briefly as those items, such as labor, which do not have salvage value.

After development is completed and production begins, the total investment in a property, as determined under the policy adopted, should be amortized on the basis of the estimated units recoverable.

Changes in accounting procedure can result in widely varying results between accounting periods. Assume, for example, that an oil company expended in two accounting periods identical amounts on its development program, but that in the first period it capitalized all of the costs, whereas in the second period it charged intangible costs to expense. The recorded expenses of the second period will have been increased by the difference between the amount of the intangible cost expenses and the amount of the depletion thereof had they been capitalized. Clear explanation of such a change in policy

and its effect on net income is necessary in order to disclose what really has taken place during the accounting period in which the change is made.

Cost Prescribed for Public Utility Companies.

Cost of Property to Person First Devoting It to Public Service.—The Federal Power Commission, the Federal Communications Commission, and most of the state commissions in uniform systems of accounts prescribed for public utilities under their jurisdiction, require that when plant constituting an operating unit or system is acquired by purchase, merger, consolidation, liquidation, or otherwise, the original cost (cost to the first person devoting it to public service) shall be charged to plant in service and that the depreciation and amortization reserve requirements applicable to such original cost of the properties acquired shall be credited to the appropriate reserve account.

Plant Adjustments and Plant Acquisition Adjustments Accounts.—Any difference between the cost to the present owners and the original cost, less accrued depreciation, must be recorded in a plant acquisition adjustments account. Revaluation increases of plant subsequent to acquisition are also required to be recorded in plant adjustments accounts.

Disposition of Plant Adjustments and Plant Acquisition Adjustments Accounts.—The amounts recorded in both of these accounts must be depreciated, amortized, or otherwise disposed of as the regulating commission may approve or direct.

Under Commission rulings, the amounts in plant adjustments accounts which usually arose through revaluation of properties are ordinarily disposed of by charge to surplus, while plant acquisition adjustments are amortized by periodic charges to income over a period of years which has been approved by the commission.

While the balances in plant acquisition adjustments accounts are usually debits, occasionally such balances are credits. Disposition of credit adjustments follows the same routine as that of debit adjustments.

Appraisals.

Purposes of Appraisals.—Appraisals may be made to determine values for many purposes, such as for consideration of adequacy of insurance coverage, or for segregation of various plant assets acquired in a lump sum purchase. They may also be made to deter-

mine fair values in contemplation of the sale or purchase of a business, to determine fair values for tax purposes or to determine the adequacy of a company's procedure in recording retirements of plant and its depreciation policy.

Standards Set by the Securities and Exchange Commission.—The Securities and Exchange Commission has issued stop-orders when, on investigation, it found that so-called appraised values expressed in balance sheets did not meet certain standards. The Commission insists that an appraisal must meet two tests: first, it must be more than an arbitrary determination, and must be based on scientific methods; and second, there must be a fair and accurate application of the methods purported to be followed. The fact that valuations are in the final analysis expressions of judgment does not warrant a departure from these standards. The Commission holds that a balance sheet containing an untrue statement through overvaluation of an asset is not curable by a footnote disclosing the overvaluation.

Upward Restatement of Plant Costs.—In the decade following 1929, the practice of entering appraised values on the books to record plant or intangible assets at amounts above their cost, less depreciation, declined. This was probably because reproductive cost appraisals would have shown lesser amounts than original cost less depreciation. With the rise in prices during World War II and the period immediately following, the subject of reproductive cost is again receiving considerable attention.

Income Tax on Appreciation.—When upward revaluations of fixed assets are recorded, depreciation should be charged to income based on the higher appraised amount (Accounting Research Bulletin No. 5, issued in April, 1940), but for federal income tax purposes depreciation may be deducted only on cost. Before the appreciation can become earned surplus, it must be recovered through sale of the assets or by realization of depreciation as part of the sales price of the company's product, but upon realization through such sales no tax deduction is allowed for depreciation on the appreciation. Therefore, fixed assets on which depreciation is fully deductible are more valuable to a company than are identical fixed assets on which depreciation is not fully deductible.

For example, if a corporation's operations are profitable, it retains $1,000 from its sales upon deduction, for both corporate and tax purposes, of depreciation of that amount based on cost. If the

$1,000 depreciation deduction is based entirely on appreciation, it is not deductible for tax purposes, and the corporation retains (at present rates) only $620 of this depreciation on appreciation. It seems evident, therefore, that assets on the books at cost are worth more to the corporate owner than assets on the books in the same amount, but a portion of which represents the excess of appraised amount over cost, because the entire depreciation on the latter is not an allowable income tax deduction.

In the authors' opinion an excess of appraisal over cost, if recorded in the accounts, should be reduced (either directly or by means of a reserve, which would be classified with the reserves relating to fixed assets) by the applicable income tax at current rates which it is expected will be paid as the appreciation is realized.

The principle involved has been recognized by the Committee on Accounting Procedure in its Bulletin No. 27, issued in November, 1946, which considers the restoration on the books of fixed assets fully amortized as emergency war facilities. In this bulletin the committee says:

> The committee recognizes that in the determination of the usefulness and worth of such facilities it will be necessary to consider . . . . the fact that no tax deductions for amortization or depreciation will be allowable in future years.

Downward Restatement of Plant Costs.—Downward adjustment of plant accounts is usually made:

1. To restate plant assets on a cost basis, through the elimination of appreciation formerly set up;
2. To reduce plant accounts on the basis of an appraisal. Such an appraisal may be the basis for the elimination of former appreciation, a reduction from original cost, an adjustment of the accumulated depreciation allowance or the recognition of a loss on plant no longer needed and therefore to be sold;
3. To reduce plant accounts to an arbitrary value such as $1.

A write-down of book amounts that cancels previously recorded appreciation of fixed assets indicates that such appreciation should not have been recorded in the first place. Whether it is proper to go further and reduce book amounts of fixed assets to amounts below their depreciated cost depends on many considerations. When based on appraisals, the goal may be merely sound values, based on present reproduction cost. In these appraisals consideration may also be given to such factors as future useful value, anticipated future earn-

ings, idle plant facilities, possibility of obsolescence before full utilization of the complete plant, relation of total productive capacity of an industry to anticipated demand for its product, and others. Occasionally a company decides to offer for sale a portion of its land, buildings, and equipment which is no longer needed in the business. If such property has an estimated sale value appreciably less than its depreciated cost it should be written down to this estimated sales value.

Little can be said in favor of writing plant accounts down to an arbitrary amount. By writing a plant down to $1, future profits will be overstated and future losses understated by the amount of the depreciation thereby anticipated. It may permit dissipation of capital investment without reflecting the fact on financial statements at the time of dissipation. It is altogether misleading both to stockholders and to prospective investors, for it implies ultraconservatism on the part of the management, when as a matter of fact it may conceal evidence of gross extravagance.

INTERNAL CONTROL

General.—A well-defined policy to govern the accounting for all additions to, and deductions from, property, plant and equipment accounts should be adopted and responsibility for its administration definitely fixed.

The procedures required to effectuate such a policy will usually include:

1. A construction expenditure budget, approved by the board of directors, showing the anticipated plant expenditures for a period, usually a year.
2. A system whereby advance approval is required for expenditures for specific projects contemplated by the construction expenditure budget, and a similar system for control of all disposals of plant. Such approval may be delegated to varying levels of responsibility depending upon the amount to be expended.
3. Maintenance of adequate property records.
4. Procedures relating to the initiation of requests for additions or disposals, the forms to be used, and the method of recording expenditures for plant assets and cost of plant removed.
5. Guidance in accounting for plant additions as opposed to maintenance and repairs.

6. A system of reporting wherein all changes in property accounts are scheduled, possibly monthly, and reviewed by a designated official as to their propriety.
7. When practicable, the occasional taking of a physical inventory of property, plant and equipment and its comparison with the book records.

Property, Plant and Equipment Records.—Property, plant and equipment controlling accounts should be supported by detailed records in which plant assets are classified in some appropriate manner. The most satisfactory control is exercised when the classified accounts are, in turn, supported by an individual record on cards or sheets, for each item of property, plant and equipment in each classification, including fully depreciated items still in use, setting forth the pertinent data. In addition to the money value, such a record should include information such as the date purchased or constructed, voucher or work order number, adequate description including the vendor's serial number, the unit number assigned, and location in the plant. The detailed records should be balanced with the general ledger controlling accounts at least annually.

Additions to Property, Plant and Equipment Accounts.—Additions should be initiated by requests for authorization to construct, purchase, or install certain facilities. These requests should be prepared by the plant engineer, plant superintendent, department heads, or other supervisory employees. Forms used should set forth information such as the necessity for the expenditure, estimated cost, description and proposed disposition of plant to be replaced, if any, and accounts to be charged or credited.

Requests should then be submitted for approval to the person to whom appropriate authority has been delegated. Approved requests are usually known as appropriations and are numbered to facilitate their identification and control. Costs of acquisition and installation should be accumulated on work orders under these numbers. All appropriations should be controlled through a construction work in progress account in the general ledger. After an installation is completed a statement of the appropriation should be prepared showing a comparison of actual costs with the cost estimate contained in the original request. Any substantial differences should be satisfactorily explained. The appropriation should then be transferred from construction work in progress to the appropriate property, plant and equipment account.

Where a company constructs, purchases, and installs substantial amounts of property additions by utilizing its own employees, costs of labor, material, supplies, and construction overhead should be accumulated and charged to construction work in progress under the appropriation or work order provided. The accumulation of these costs should be watched carefully throughout the construction period to avoid, if possible, exceeding the original cost estimate. Timely information may result in appropriate corrective action being taken during the construction period.

To avoid the capitalization of minor items under routine construction work orders, some companies capitalize only those expenditures which exceed some minimum amount, varying with the size of the company. Such a policy is expedient, if wisely administered. Care should be exercised on partial billings or related work orders which, when taken individually, may be treated as repair items but which in their aggregate properly may be capitalized. Furthermore, if an expenditure is in excess of a set minimum, it does not follow that it represents a capitalizable item.

Reductions in Property, Plant and Equipment Accounts.—Retirements of property, plant and equipment should be controlled in the same manner as additions. Requests for authorization to retire, sell, transfer, dismantle, or abandon property may be submitted to the same person authorized to approve additions. Such requests should set forth the necessity for the proposed transaction, a description and the recorded cost of the item to be retired, estimated salvage, estimated cost of removal, and the proposed accounting entries.

After approval, work order or retirement numbers should be assigned for convenience in accumulating costs of the retirement, and the procedure in all ways should be similar to that relating to additions.

Physical Inventories.—When individual records of plant items are kept, a physical inventory should be taken occasionally and compared with the detailed records. The inventory preferably should be taken by persons, not responsible for either the custodian or accounting functions, who are reasonably familiar with these assets. Any discrepancies between the physical inventory and the book records should be reported promptly to management, and, when the difference is material, a thorough investigation conducted and the accounts adjusted when required.

Information obtained from periodic studies of property for insurance purposes may be used to check book records.

AUDITING PROCEDURES

Auditor's Responsibility.—The auditor's responsibility with reference to property, plant and equipment differs somewhat from that relative to current assets. As to current assets, if his report is unqualified, he should have arrived at an opinion as to the existence, basis of statement, and apparent realizability, on a going concern basis, of the amount at which such assets are stated. As to property, plant and equipment, the auditor is not responsible for substantiating their existence to the extent of making physical tests and inspections of them. However, in addition to evidence obtained from the examination of accounting and other records, most auditors consider it desirable to make an inspection tour of the property as a whole, not only to acquire assurance that there is a plant in existence, but also to acquire a background for the examination of the records.

The auditor has no responsibility as to the realizability of the amounts at which property, plant and equipment are recorded in the accounts. He should attempt to ascertain whether property, plant and equipment as a whole is fairly stated in the accounts, and, whether surplus equipment, held primarily for sale, is segregated in the accounts and included at estimated realizable value.

When title does not rest in the company, the auditor should ascertain the nature and extent of the company's interest.

General Auditing Procedures.—The auditor's objective in his examination of plant, property and equipment accounts is to establish reasonably whether the book figures represent cost, appraised value, or some other basis, and whether generally accepted accounting principles have been consistently applied in past as well as current periods.

When an audit covers several years, or a period since inception of the enterprise, an analysis of the items of property, plant and equipment is made in due course and the auditor then usually has an understanding of the composition of the various property accounts and the accounting principles which have been followed. When the accounts are being examined for the first time, and the period to be examined is not more than one year, a question arises as to the extent of the examination which the auditor reasonably may be required to make.

As a minimum, the auditor should review available plant records and prepare or obtain analyses reflecting annual changes for prior years. Any large or unusual items should be investigated in an effort to learn of any revaluations or other important adjustments. Charges for property paid for by issuance of common stock or bonds, particularly when mixed aggregates of property are acquired, should be investigated to ascertain the basis on which these acquisitions are recorded, and to ascertain the basis for any allocations resulting from lump sum purchases.

In registration statements filed under the Securities Act and the Securities Exchange Act, the registrant and the accountant certifying the financial statements are permitted by the instructions to report the balances in the accounts for property, plant and equipment "as per the accounts" at the beginning of the period for which the financial statements or supporting schedules are submitted (or as per accounts as of the close of the most recent period for which certified statements are on file). The registrant is required to submit certain historical data as to property, plant and equipment (see Chapter 22), and if the company under examination has ever filed a registration statement this information is available and may be helpful to an auditor making a first examination of the company.

If the auditor cannot obtain acceptable details in support of the basis on which the plant accounts purport to be stated, or if he finds that proper accounting principles have not been consistently applied, it may be necessary to qualify his opinion of the balance sheet.

The auditor's procedure in examining the property, plant and equipment accounts will be affected materially by the system of internal control over the recorded transactions. Control of additions to plant by a system of appropriations, supported by work orders which accumulate charges to the various projects, facilitates the differentiation between plant and expense charges since similar items may be properly chargeable to either, depending on the purpose of the expenditure. For example, copper pipe may be used either to repair existing plant, or as part of a new installation.

When charges are made directly to classified accounts, the auditor may experience difficulty in judging the propriety of the classification, since the purpose of the expenditure is not as clearly evident as when a work order system is used.

Application of Auditing Procedures.

Under Work Order System.—When a work order system is used, those work orders applicable to approved authorizations for

capital expenditures are usually identified by number and are the basis of the accounting.

Authorizations for the period of an examination may be divided into two classes, those for completed projects and those for uncompleted projects.

Some companies classify expenditures for plant additions as construction work in progress until all work orders assigned to the particular project are completed. This practice is not desirable if a completed portion of the construction is in service, for it results in a delay in the transfer of completed work to the proper accounts and in the initiation of depreciation allowances. At the end of a fiscal period, all completed work orders in service should be closed to the property accounts, and the remaining balances should represent expenditures on uncompleted projects.

The auditor should satisfy himself that the remaining balances of uncompleted work orders applicable to appropriations represent the cost of uncompleted work. In addition to making a partial or complete check of entries, the auditor should review the balances of all large projects to ascertain whether charges for completed work have been transferred to plant accounts, whether proper disposition in the accounts has been made of projects subsequently abandoned, and whether there is any significant amount representing dormant projects the completion of which has been unduly delayed.

Sometimes work orders are used as clearing accounts for entries relating to plant removals or abandonments. Where this procedure is followed, it is important that these items be excluded from the amount to be shown on the balance sheet as construction in progress.

Construction work in progress sometimes includes work orders which have been assigned for the accumulation of repair costs. Balances of such work orders at the end of each accounting period should be closed to expense.

With respect to all work orders applicable to approved authorizations, the auditor may usually satisfy himself as to the propriety of additions and retirements by the following procedures:

Review the descriptions of authorizations to determine that the work described appears to be properly chargeable to plant accounts, and, if retirement of plant displaced is involved, that proper recognition thereof has been made in the accounts.

Select the more important, unusual, and questionable work orders for investigation in detail.

Review charges for labor and material on selected work orders,

vouch representative direct purchases (including work by outside contractors) and investigate charges for transportation, overhead, and supplies.

Compare expenditures authorized or estimated with the actual costs as finally determined, and obtain explanations of substantial variances. If the variances cannot be explained satisfactorily, investigate further the accuracy of the accounting for expenditures.

In Absence of Work Order System.—When a work order system is not in use, the auditor should adopt procedures appropriate to the situation.

When plant additions consist of units acquired from outside vendors, invoices should be examined. The auditor should also see whether these purchases, at least with respect to the principal items, have been properly authorized.

Insignificant small items should not be capitalized. The additions to plant accounts for a given period should be reducible to definite groupings, and it is usually helpful to obtain a memorandum describing the principal additions and improvements which have been undertaken or completed during the period.

Even though a concern does not control capital expenditures through work orders, there is usually a storeroom system and many of the charges to plant accounts will originate in storeroom requisitions.

It may be impossible to determine after the lapse of some time, by mere inspection of supporting vendors' invoices or storeroom requisitions, whether a debit should be made to one account or another. Nevertheless, the auditor should compare a number of the documents supporting charges to property accounts with the related ledger entries, not only to ascertain that the entries have been correctly posted with respect to both account and amount, but also that, insofar as he can determine, they relate to items properly applicable to the accounts to which they have been charged.

In his examination of original data in the support of accounts other than property, plant and equipment, such as maintenance and repairs, the auditor should observe the policy relating thereto and watch for items that should have been charged to property accounts rather than to expense.

If construction work to be capitalized is based upon contracts, the auditor should examine the contracts and compare charges to property accounts with amounts called for by the agreements. After

contracts have been signed, changes in the specifications are frequently authorized. The auditor should ascertain that extras appear to be justifiable additions to the cost of the work and have been properly approved.

Frequently an architect's or engineer's certificate is required before final payment is made to the contractor. Although the auditor should examine such a certificate, which usually relates to cost features of contracts as well as to performances, he should not place too much reliance on it, unless the contract calls for a lump sum payment and the detailed costs are not available for the auditor's inspection. In one instance, the entire cost of an audit was met through recoveries the client was able to obtain as the result of errors discovered in charges under a building contract. The architect had certified not only that the building had been completed according to specifications, but that all cost relative to its construction had been correctly computed and billed.

The auditor should review whatever collateral evidence of ownership and amount of property, plant and equipment additions is available. Deeds, tax receipts, insurance policies, purchase contracts, all may be confirmatory of book entries or point to errors or omissions in the accounting for property and equipment.

Plant Retired from Service.—The auditor should satisfy himself that physical retirements have been properly recognized in the accounts. Such retirements usually occur in connection with renewals, replacements, or abandonments of plant. In his consideration of retirements not recognized on the records, the auditor should review construction work orders, records indicating sale of scrap or salvage, and make inquiries of the engineering staff, construction superintendent, or production head, and explore any other source of information which may be available.

With respect to the pricing of retirements, the auditor should ascertain whether all items of cost, including installation costs and overhead, appear to have been included. When property accounts appear on the books at appraised amounts, retirements should be made on the basis shown by the appraisal. Appraisals are sometimes taken up on the books at a date later than the date as of which the appraisal was made; in such instances, retirements during the interim period should be adjusted to the appraisal basis.

Real Estate.—Ownership of real estate may be indicated by the absence of expenditures for rent, by unchallenged use and occupancy of the premises, or by the receipt of income therefrom. Expenditures

for such items as taxes, building repairs, and interest on mortgages payable, should put the auditor on notice that the client is the owner of at least an equity. Inspection of available deeds, contracts of purchase, settlement papers, insurance policies, minutes, and correspondence may further substantiate ownership. While such evidence is not always conclusive, the auditor may often be justified in accepting it as prima facie evidence of the ownership of real estate. Serious flaws have been found in the titles to real estate carried as assets on balance sheets which have been accepted as a basis for credit.

Generally, when a question of title is indicated, the most practicable method of confirming title to real estate is to secure from the client's attorney or from a title company a letter or certificate stating such information as may be applicable in the circumstances, as, for example:

1. Whether title to the real estate as it appears, or as it is described on the books, is in the name of the individual, firm, or corporation under examination;
2. Whether the real estate is free from encumbrances, such as the following:
   (a) Mortgages,
   (b) Judgments,
   (c) Taxes or other municipal liens,
   (d) Possibility of reverter, because of failure to fulfill conditions in the contract of sale, for example, that a plant will be erected within a stated time or a specific number of men will be employed.

If possible, the cost of building sites should be separated from the cost of buildings and other improvements. If improved real estate is purchased, the auditor should obtain information that can be used as a basis for substantiating the apportionment of the cost of the property between land and improvements. Tax receipts and insurance policies may be useful, as well as appraisals made in anticipation of the purchase even though not reflected on the books.

It is not often that the entire consideration for the purchase of land or improved real estate is paid in cash. Frequently bonds or stocks are issued in payment therefor. Usually these items can be substantiated by reference to the minutes of boards of directors, the contracts themselves, or the acknowledgments of the payees.

Buildings.—When a considerable amount is being expended on new or old buildings, the payments should be vouched by the auditor.

The construction as a whole should also be checked with authorizations of the board of directors or executives in charge of the work, and with bids or estimates submitted before work was begun.

Machinery, Tools, Fixtures, and Other Equipment.—Purchases of machinery, large tools, fixtures, and other equipment should be analyzed to determine whether they represent actual additions to plant equipment or renewals of existing facilities. Vendors' invoices should be examined in support of larger items and in support of other items selected at random. Installation costs, freight, labor, and other charges to the equipment accounts should be investigated to the extent deemed appropriate.

If machinery is purchased on deferred payments, the auditor should examine the contracts and ascertain that the total cost is charged to the asset account at the time of acquisition, and that provision is made for depreciation on the full cost from the date when the machinery is placed in operation.

The status of installment payments should also be investigated, for if at the time the balance sheet is prepared any installments are overdue, or if they have not been paid promptly, the equity may have been lost through right of repossession of the machines by the manufacturer.

If machinery is purchased under royalty agreements, the auditor should also examine agreements and ascertain the status of any liabilities thereunder.

Sometimes machinery is leased rather than purchased. There is little basis for including any amount for leased machinery in property, plant and equipment, since the lessee has no equity in the title. As a matter of record, however, some companies include leased machinery at a nominal amount. In any event, the lease agreements should be examined to determine the status of the lessee's position with respect to leased machinery.

The auditor should inquire if a detailed record is available showing the particulars of the cost of the machinery and equipment. This record is found usually on cards or in a loose-leaf book, and, if reliable, is very helpful. The record should show how and when items were acquired, as well as such information as cost of acquisition and installation, amount allowed each year for depreciation, and location in the factory. In the absence of a formal detailed property record, an informal record may sometimes be kept for insurance purposes and should be examined for whatever information it may reveal.

Automotive Equipment.—The auditor should ascertain the number of vehicles in use in order to see whether provision has been made for those sold, exchanged, or scrapped. Although all vehicles depreciate rapidly, and the useful life of automotive equipment is usually short, it must be remembered that the nature of these assets is such that repairs may prolong their life to a considerable degree. For instance, the motors may be replaced, and bodies entirely rebuilt.

The file of ownership certificates, which are issued to owners in most states and contain information such as the kind, motor number, and registered owner of the vehicles, may be useful to the auditor.

Patterns, Drawings, and Lasts.—Patterns, drawings, and lasts frequently represent large expenditures by manufacturing concerns and the book amounts are sometimes difficult to substantiate. If they are used for stock or regular production, their value depends upon their life and upon the probability of continued use. If acquired or made for special jobs, their residual value is small, and their cost should be charged to the special jobs. These items should be reviewed and substantial proof should be available to support any material valuation of them.

The auditor may meet with strong opposition in his efforts to have these items reduced to a reasonable amount, for they represent the skill of the proprietors who often look upon them with affection, and dislike to see them written down. However, the auditor must decline to accept sentimental values as tangible assets.

Demands of the public change, and patterns must be made to suit the changing taste. Even styles of what appear to be standard patterns for stable businesses change rapidly. When demand ceases, patterns become worthless and should be written off. In some lines of business change in demand can be anticipated considerably in advance of the time when sales of a particular article will cease. The auditor should inquire about prospective changes and ascertain that what appears to be adequate allowance for obsolescence is being made with respect to patterns still recorded on the books.

Returnable Containers.—When deposits are obtained, the examination of the returnable containers account should include inspection of at least a part of the quantities on hand and computation of the quantities held by customers at the balance sheet date. Memorandum records should be available which show the number of containers held by customers or, if the deposit liability account

has been kept accurately, the number can be determined by dividing the amount of the deposit liability by the deposit per container. After sufficient experience has developed on which to base an estimate, the percentage of containers which will never be returned should be estimated and entries made periodically to remove the cost of these containers from the property account and the deposits from the liability account, taking profit or loss to the income account.

The auditor should compare the amount of the deposit per container with the cost per container. If the amount of the deposit required is more than the cost, the company will make a profit on each container not returned; if the amount of the deposit is less, the company will sustain a loss. In the latter event, the auditor should consider the necessity of establishing a reserve for loss on those containers which may not be returned.

If the company follows the practice of accepting containers of competitors and allowing credit equal to the amount of the regular deposits, such acceptances are equivalent to purchases and should be so recorded on the books of account.

When containers are furnished free with an obligation to return them, it must be assumed that customers treat the obligation lightly and that in addition to the usual losses and breakages, a considerable proportion will not be accounted for. If feasible, an attempt should be made at some convenient time to take an inventory of containers on hand and in the hands of customers which are known to be recoverable. A comparison of such an inventory with the book inventory may provide a sound basis for determination of an expense rate or for estimating an allowance for depreciation. If an inventory is not possible, the auditor must make his own calculations as to the number of containers required for the normal operation of the business. He should then inspect the reserve supply and, unless furnished with proof that a larger quantity exists, decline to approve an inventory of a greater number than is thus disclosed. Many concerns assume that all returnable containers will be returned in due course, but this assumption is unwarranted, for experience proves that a considerable percentage is lost, broken, or stolen.

When containers such as kegs, crates, and syphons are used without a deposit requirement, the customer being obligated to return them, the most common and probably the most satisfactory method of handling is to note the quantities in the sales book and to post the items to the customers' ledger, in which a special column should be provided on both debit and credit sides. A test of the records of returnable containers in the hands of customers should be made.

The auditor should also investigate the method of inspection and the method of authorizing credit for returned containers. If the receiving clerk is careless or inefficient, the number of containers returned may not be verified, and damaged or broken containers may be passed as in good condition. The clerk in charge of credits should not be allowed to establish practices with respect to prices or freight allowances.

Mines.—In the examination of mine accounts, the auditor should follow procedures previously suggested for examination of real estate, insofar as title and encumbrances are concerned.

In examining the amount at which mining property is carried, the auditor may not have much to guide him. He should keep in mind the fact that as operations proceed value of the mine property decreases, unless development and exploration work discloses new values. An analysis of original cost, taking into consideration the engineer's estimates of total contents, is a valuable check on the allowance for depletion. It may not be customary to submit the engineer's records to the auditor, but the latter is on notice that no well-managed mining company attempts operation on a large scale unless fortified by the scientific calculations of skilled engineers.

Leaseholds.—The auditor should read all leases and note any important provisions. He should substantiate any premiums paid by examination of supporting evidence.

Appraisals.—Values reported as the result of appraisals often are not recorded on the books. When they are recorded the auditor should secure a copy of the appraiser's report, inquire as to the basis upon which the appraisal was made and examine the adjustments made on the books to ascertain whether they properly reflect the appraisal amounts.

It is not good practice for the auditor to accept appraised values without question, even when the appraisal is made by a reputable firm of appraisers. This does not mean that the auditor should in any way criticize the appraiser's report as if he were a qualified appraiser, but rather that the auditor should read the appraiser's report critically to determine the basis on which the appraisal was made.

In some highly specialized industries, professional appraisers may not be considered as well qualified to determine the proper value of special machinery, dies, patterns, and molds peculiar to the industry, as are those intimately connected with their operation. When appraisals have been made by engineers or officers of the company, the

auditor should inquire as to the qualifications of the individuals who made the valuations and as to the methods used by them.

An entire plant may be acquired in exchange for common stock of the acquiring company. In the absence of an appraisal the problem of valuation is a difficult one. Instead of assigning the task to independent appraisers or company engineers, the board of directors may undertake to value the property and fix the value of the assets acquired at an amount sufficient to offset the par or stated value of the stock issued therefor.

Since the directors may not be expert and are not independent, the auditor should review all available information and consider whether he should take exception to the appraised values in his report.

If, as a result of an appraisal, downward revisions of property, plant and equipment are made, the auditor should investigate the basis for the revisions and make a comprehensive review of the entries recording the adjustments in the same manner as if the adjustment had been upward.

Coordination of Examination with That of Related Accounts.—During the course of his examination of the property, plant and equipment accounts, the auditor should have in mind the relation that the information and documentary evidence he is examining in support of such accounts has to other accounts. For example, the examination of original documents supporting the acquisition of equipment may indicate the existence of liens of various kinds, that the equipment was purchased on the basis of installment payments, or that a balance is due at some later date. The auditor should ascertain the nature of such liens, and that they are recognized in the accounts. He should ascertain the present status of the liens, and whether the accounts correctly reflect unpaid installments or balances still payable. Such information should be traced to the related general ledger accounts.

As indicated heretofore, the accumulation of data relating to yearly additions and retirements for past periods will expedite the review of repairs and the allowance for depreciation. Data relating to additions and retirements for the period of the examination should be accumulated in such a manner that they can readily be checked to authorizations in the minutes of the board of directors or elsewhere.

Information relating to adjustments of the plant accounts involving contra entries in the capital or earned surplus accounts should be accumulated in such a manner that the related entries in the latter accounts may readily be checked.

Examination of plant accounts should indicate whether expenditures for maintenance and repairs have been capitalized; examination of expense accounts should indicate whether expenditures for plant assets have been charged to maintenance and repairs.

Time of Examination.—In the auditor's first examination of a company's accounts, substantially all of his investigation of property, plant and equipment acquired in prior periods can be conducted well in advance of the balance sheet date. He can analyze not only the general ledger accounts, but also summarize available records which may indicate the principles or procedures on which the accounts have been established. Additions and retirements can be summarized by years. Collateral and historical data can be reviewed. Major additions and acquisitions can be investigated, and all the assembled information studied to formulate an opinion as to the reasonableness of the book amounts.

In subsequent annual examinations, the auditor can expedite his work upon the property, plant and equipment accounts by conducting a preliminary audit of transactions recorded for possibly the first ten months of the period. After the close of the year, he may complete his examination of the transactions for the remaining two months.

STATEMENT PRESENTATION

General.—No one designation of property, plant and equipment on the balance sheet has been accepted to the exclusion of others. "Property, plant and equipment," "fixed assets," "land, buildings, machinery, and equipment," "general property," "properties," "plant, equipment, and real estate," and numerous other captions will be found in published financial statements. In condensed balance sheets, only one amount may appear on the balance sheet to show the aggregate amount of the items to which the caption applies.

Preferably, nondepreciable property, such as land, should be segregated from depreciable property, such as buildings and machinery. Real estate used in the business should be stated separately from real estate not used in the business. Excess land, buildings, and equipment being offered for sale, if material in amount, should be stated separately from property in use, at not in excess of estimated realizable value. Construction work in progress, if significant in amount, may be stated separately, or if included with completed projects, may be indicated parenthetically.

If a company is in the business of buying and selling real estate, properties held for sale constitute inventory, and should not be in-

cluded under property, plant and equipment. It is a practice in many such companies to reflect in their statements only the equity owned in property held for sale, when purchased subject to a mortgage or other liens. When liability under the mortgage is assumed by the purchaser, the proper treatment is to show the mortgage as a liability and the property at its gross amount.

The amount of accumulated allowances for depreciation or depletion should be shown on the balance sheet either as a deduction from the assets to which they relate, or in total from the total of the depreciable or depletable assets. Sometimes the plant assets are shown after deducting the related allowances for depreciation or depletion, but, if so, the amounts of allowances should be indicated parenthetically or by footnote. Except in balance sheets of public utilities, it is ordinarily not good practice to show allowances for depreciation and depletion on the liability side of the balance sheet. The exception stated is presently recognized and approved by the Securities and Exchange Commission (Regulation S-X, Rule 3.11).

Gross cost of facilities purchased under the installment plan should be shown among the assets, with the lien, if material, indicated. Unpaid installments should be shown among the liabilities. It is not good practice to state in the balance sheet only the client's equity in installment purchases, even though title to the property remains in the vendor until the completion of the purchase contract.

Property Stated on Cost Basis.—It has long been an accepted principle of balance sheet presentation that, unless there is a notation to the contrary, the reader may assume that property, plant and equipment is carried at cost less accrued allowance for depreciation. Cost means cost in cash or its equivalent.

When plant assets are carried at cost, less accrued depreciation, there is no need of reporting replacement values. Some lawyers and corporation officials, however, have been apprehensive about stating plant assets at cost, less depreciation allowance, in a balance sheet, at a time when current replacement may be materially above or below the carrying figure, for fear that in the absence of explanation such presentation might be construed by the courts as false or misleading. The question may be regarded as significant, for example, in the case of an issue of mortgage bonds offered for sale in a period of declining prices when an appraisal of the properties covered by the mortgage bonds at reproduction cost may be less than the actual cost paid for the property. There is no objection to appending a note to the balance sheet avowing that the amount carried for plant and

property does not purport to represent reproduction cost or present value, or stating any facts deemed to have a pertinent bearing on the value of the property.

Property Stated on Bases Other Than Cost.

Amounts Fixed by Appraisals.—When plant assets are carried at appraised values, the balance sheet should so indicate in a clear and understandable manner. It is considered good practice to state in the descriptive matter the fact that the appraisal was made by independent appraisers, the date of the appraisal, and the basis of the appraisal. The auditor should inform the appraiser of the language proposed to be used and ask for his approval or suggested modifications.

If the appraisal was made by the board of directors, by company engineers, or other employees who may not be considered independent, that fact should be indicated clearly. As stated elsewhere, if a study of available data indicates to the auditor that amounts recorded are not reasonable, he should make a suitable qualification in his report.

Restatements Made Pursuant to Orders of Regulatory Bodies, Etc.—When property, plant and equipment accounts are restated pursuant to orders of regulatory bodies or to plans of reorganization or corporate readjustments, the nature of the restatement and the amounts should be indicated clearly.

Idle Plant, Reserve and Stand-By Equipment.—It is accepted practice to include in plant assets on the balance sheet property in use and property held with reasonable expectation of its being used in the business. It is not customary to segregate or indicate the existence of temporarily idle plant, reserve, or stand-by equipment. Property abandoned and facilities no longer adapted for use in the business should be segregated or removed from plant accounts, or an appropriate explanation should appear on the balance sheet.

When a material portion of the plant and equipment has been idle for a protracted period with no apparent likelihood of resuming operations, the amount of these facilities should be set forth separately with an appropriate caption. If a substantial portion of the total plant facilities remains idle for long periods, that portion involves a continuing unnecessary expense, and creditors, stockholders, and others interested should be apprised of the fact that the property, plant and equipment is owned to an extent greatly in excess of apparent reasonable needs.

Fully Depreciated Plant Items.—As the allowance for depreciation is at best an estimate, facilities may be operating after full depreciation has been provided on the books. Questions arise with respect to the treatment of material amounts of fully depreciated items. One of the following treatments may be adopted:

1. The amount of fully depreciated items may be included in the gross amount of property, plant and equipment, and the related allowance for depreciation may be included in the accumulated allowances for depreciation;
2. The amount of fully depreciated items may be removed from the respective property, plant and equipment and allowance for depreciation totals, and shown separately on the balance sheet;
3. The amount of fully depreciated items may be written off against the related allowance for depreciation, so that no amount appears in the balance sheet.

Some accountants contend that the third method is most desirable. In the opinion of the authors, however, if facilities are in use by a concern, the recorded amount of fully depreciated items should be included in the balance sheet. Whether the first or second method is employed depends largely on the importance of the amount.

CHAPTER 13

DEPRECIATION AND DEPLETION

Introduction.—The subject of depreciation is one which has engaged the attention of accountants for many years, and the volume of accounting literature devoted to it is vast. The necessity for an allowance for depreciation of tangible fixed assets is now generally accepted, but the meaning of depreciation as reflected in financial statements is less generally understood. The Committee on Terminology of the American Institute of Accountants, in Accounting Research Bulletin No. 22, issued in May, 1944, has defined depreciation accounting as follows:

> *Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. *Depreciation for the year* is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

The reader may also refer to Accounting Research Bulletins No. 16, issued in October, 1942, and No. 20, issued in November, 1943, in both of which the term depreciation is discussed in detail.

Depreciation Accounting vs. Physical Depreciation.—Physical depreciation of property, plant and equipment is generally understood to be the ordinary loss in useful life caused by wear and tear from operation and by deterioration resulting from chemical reactions from air, water, gas or other elements. In varying degrees, it takes place whether machinery is operated or is idle, whether it is well cared for or neglected, whether it is built from materials of good quality or constructed from scrap. The layman may have difficulty in reconciling the concept of accumulated depreciation allowance. representing perhaps 50 per cent of the cost of the related plant items with physical or so-called actual or observed depreciation. In many instances the courts are also unable to reconcile such seeming inconsistencies. In the experience of the authors, there is usually no direct relationship between physical evidence of depreciation and book allowances reasonably and carefully determined by the application of generally accepted principles of depreciation accounting.

Depreciation as used in accounting is not the same as physical depreciation. It is the translation into monetary units of the normal loss of total service life of property, plant and equipment. In order to estimate fairly the money equivalent of this diminution to be recorded in the accounts, considerations other than the physical depreciation of property must be recognized.

ACCOUNTING PRINCIPLES

Depreciation.

General Principles.—To accountants the basic concept of depreciation accounting for property, plant and equipment is the absorption of investment in productive facilities through amortization, distribution or allocation of its cost, less salvage, by systematic and

reasonable charges to operations over the useful life of these facilities. When these facilities are expected to have a useful life for a shorter period than physical life, the cost properly may be depreciated systematically over the period of their expected economic usefulness.

Consistency in Application.—The accounting recognition of depreciation and the reasonableness of depreciation allowances necessarily are based upon an estimate of service or economic life; this estimate should be a fair one based upon experience and modified by intelligent consideration of existing circumstances and future possibilities. When a sound depreciation procedure has been decided upon, it should be applied consistently until fundamental conditions change to such a degree that its application no longer produces reasonable results. If accounting provisions for depreciation are not consistently computed, comparisons of income accounts for the affected periods may be either useless, misleading, or both.

The maintenance of a consistent depreciation accounting policy does not necessarily imply or require that the rates of depreciation must be inflexible. Circumstances may arise which make it desirable to accelerate allowances for depreciation. For example, when production is abnormally heavy, physical depreciation may be greater than was expected when the rates were established because there is less opportunity to repair and maintain machinery properly or because the machinery may suffer under the divided responsibility of a multiple-shift system. When such conditions arise, studies should be made to determine whether the useful life has been shortened and, if it has, to what extent this should be reflected in revised rates. When cessation of demand is foreseen or radical new inventions threaten the ability of old machines to compete with them, an effort should be made to absorb the undepreciated cost of the equipment during its remaining useful or profitable life.

Basis of Depreciation Accounting.—*Cost.*—That the proper basis for computation of depreciation is cost has long been recognized not only by business management and public accountants but also by the Interstate Commerce Commission and many other regulatory bodies. It is further recognized that unrecorded increases or decreases in the market value of the property, and the fact that its cost of replacement may be greater or less than the amount at which stated in the accounts, ordinarily have no bearing on the amount to be recovered through depreciation charges to operations.

Replacement Cost.—The sixth edition of this book, in discussing the theory of basing depreciation upon replacement cost, stated in part:

> It has often been advocated that computation of depreciation should be based upon replacement cost. The contention is that it is the replacement cost of a plant, rather than the actual cost, for which provision should be made . . . .
>
> This suggestion overlooks the practical impossibility of determining in advance what the eventual cost of replacement will be . . . Another impractical aspect of the suggestion is that a plant is not all replaced at one time; consequently, under the suggested plan many different price levels would have to be used or assumed for the different years in the future when it is estimated different parts of the plant would require replacement. Changing manufacturing processes and designs over the years would be another factor which would preclude practical application of the suggestion.
>
> The suggestion, further, is in conflict with the basic concept of periodic depreciation allowances, namely, that they are to amortize the investment in plant—a definite amount, if actual cost be used; a wild guess, if estimated replacement cost be used—over its useful life.

The sharp increases in price levels in recent years again have produced agitation for basing depreciation on replacement cost. Accounting Research Bulletin No. 33, issued in December, 1947, on "Depreciation and High Costs" says in part:

> The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.
>
> The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of "inflated" dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.
>
> When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is en-

> tirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.
>
> It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps, there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.
>
> It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

In a letter to members of the Institute dated October 14, 1948, the Committee on Accounting Procedure reaffirmed the opinion expressed in Accounting Research Bulletin No. 33.

It is the authors' opinion that, in the long run, the practice of the majority of well-managed business concerns as to the basis of providing for depreciation would be accepted by professional accountants generally. Successful business does not remain successful by following unsound policies. It is therefore of great interest to note that in reply to a recent questionnaire sent to a considerable number of officers of corporations in various lines of business, a very decided majority were strongly in favor of continuing to provide depreciation based on cost, rather than on current replacement values.

In Accounting Research Bulletin No. 5, issued in April, 1940, the Committee on Accounting Procedure stated that when appreciation (unrealized increment) has been entered on the books, income should be charged with depreciation computed on the new and higher values with a corresponding credit to the allowance for depreciation of the related assets. The authors subscribe to the conclusion of the Committee which follows:

The committee is of the opinion that when such appreciation has been entered in the books, income should be charged with depreciation computed on the new and higher values. This proposition is the most important part of the present statement and for it there seems to be general support. A corporation should not at the same time claim larger property values in its statement of assets, and provide for the amortization of only smaller property sums in its statement of income.

It is recognized that in the past the contrary view has been held in the profession and in other authoritative quarters, and in some cases it may be unreasonable to require a corporation to change a treatment adopted in good faith in the past. The committee believes, however, that a change to conform to the views now expressed is very desirable, and that members of the Institute should exercise their influence to the utmost to bring about such changes.

Methods of Application of Depreciation Rates.—Before discussing the various theories for determining depreciation rates, it is desirable to consider a fundamental distinction in methods generally used in application of the rates. There are two methods in general use: the unit life method and the composite life method.

Unit Life Method.—Under the unit life method of depreciation accounting, theoretically each item of equipment is considered individually in determining a proper rate for depreciation. If the unit life method is employed and if property is retired or sold before the end of the previously estimated useful life, the resulting profit or loss is reflected in the income account for the period in which the property is retired.

Composite Life Method.—The composite life method in general is predicated on the theory that the group of items to which it is applied has a reasonably determinable average useful life and that the period by which the actual useful life of certain items falls short of the general average will be compensated for by useful lives of other items extending beyond the average. It is assumed that if a group of like assets has an average useful life of ten years and if one item is retired at the end of seven years, it is probable that the average will be preserved by the continuance in service of another item for thirteen years. If the composite life method is used, it is desirable that depreciable assets to which it is applied be segregated into as many natural groups as is feasible under the circumstances. This segregation will facilitate the initial determination of reasonable rates and provide a basis for subsequent periodic reconsideration of the adequacy of the rates selected. The composite rate should be

redetermined whenever substantial changes occur in the relative proportions of items with longer or shorter lives within the particular group of assets.

Upon normal retirement the cost of property retired is credited to the appropriate asset account and debited to the allowance for depreciation. The latter account is also credited with salvage on normal retirements of property. The effect is to spread the remaining undepreciated balance of cost of early retirements over future periods. When assets are sold or retired because of casualty or special obsolescence, the allowance for depreciation should be debited only with an amount equal to estimated depreciation and obsolescence accrued to the time of such retirement and the balance of the cost may be charged to income.

Methods of Determining Depreciation Rates.—A reasonable rate of depreciation is based on the prospective useful life of the property when acquired. In estimating useful life, the conditions under which the property is used, normal obsolescence, possible salvage value, and the effective policy of repairs and replacements must be considered. After the initial determination of depreciation rates, they should be periodically reviewed, and, if changed operating conditions warrant, adjusted.

Allowance for Obsolescence.—No manufacturer can depend on keeping his plant operating profitably and successfully merely by renewing existing equipment with similar equipment. He must be prepared to replace machinery with improved equipment as it becomes available. It is inevitable that improvements will continue as long as we have inventors and men of initiative and it is therefore only reasonable that normal obsolescence in existing property should be recognized in determining depreciation rates.

A careful estimate of the useful life of depreciable assets should recognize possible future inadequacy of equipment. Over a period of years most successful concerns increase the volume of production or service, and this may necessitate the discarding of equipment of small capacity before it is worn out in favor of equipment of greater capacity which can be more economically operated. This obsolescence also should be recognized.

There are types of equipment, such as high-speed automatic machines, which require periodic overhaul and replacement of worn parts, for otherwise they lose their quality of precision. Thus their physical life may be extended indefinitely, and obsolescence may be even a more important factor than physical exhaustion in determin-

ing the length of useful life. Such obsolescence may result because of a change in demand for the product which the machine is equipped to produce, or because of the development of a new machine which can produce the same product at a lower unit cost.

The manufacturer who wishes to allocate the cost of the machine to production reasonably will charge costs periodically with an amount which he believes will enable him to discard the machine without loss when a better one appears or when there is no longer a demand for its product.

Equipment which under normal circumstances might be considered obsolete may, for particular reasons, continue to have value in use. Mining equipment which has been transported into mountain mining camps at great expense may theoretically have become obsolete because of the introduction on the market of more efficient equipment for doing the same work. But the cost of replacing old equipment with new may be so great that the cost per unit of production may be appreciably greater than that with the old equipment. The old equipment, technically obsolete, then continues to have useful value.

If the enterprise is one which deals with depletable assets, consideration must be given to the possibility that available coal, metal, oil, gas, or timber of commercial value may become exhausted before the expiration of the physical life of other assets and, as a result, make the useful service life of equipment used in production of wasting assets shorter than it would be otherwise. It is not unusual to find that, when a mine closes down, equipment on hand is worthless because to dismantle and remove it from the mine would cost more than would be realized upon its sale. When these factors have been taken into consideration, the period over which the depreciable assets will be written off will not necessarily represent the estimated physical life of the assets, but the estimated service life of the assets to the company as a going concern while used for the purpose for which they were acquired.

It is not customary or significant to attempt to measure separately and provide for obsolescence as opposed to the element of wear and tear or exhaustion. It should be understood by readers of a balance sheet that the allowance for depreciation may, and usually does, include an allowance for normal obsolescence.

The expected term of profitable use of a plant and the expected trend of profits during this term have a material bearing on the depreciation policy followed. On this point Accounting Research Bulletin No. 33, issued in December, 1947, says:

. . . . the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness.

Relation of Repairs and Replacements to Depreciation.—Due regard should be given to expenditures for current upkeep or maintenance when considering the sufficiency of charges to operations for depreciation. In some industries physical depreciation is so rapid that special treatment may be desirable. Small tools, dies, jigs and molds are outstanding examples of items which depreciate so rapidly that frequent inventorying is often the only practical method of determining a proper allocation of expenditures to operating expenses. Charging the cost of replacements of such items to maintenance in lieu of depreciation may be satisfactory under certain conditions.

The policy of a company may be to include the cost of major parts of machines which are constantly wearing out and breaking as maintenance expenses. In some machines nearly every part is renewable so that it is not unusual to find that eventually the machine has been completely rebuilt. The efficiency of the machine may be practically constant until just before it is scrapped, yet depreciation under the accounting concept accumulates during the entire life of the machine. When near the end of the estimated life of property neither obsolescence nor inadequacy is evident and it appears that the machine can be maintained in efficient operating condition for some time beyond its previously estimated life, it may be proper to decrease depreciation rates. Such an adjustment is not ordinarily advisable early in the useful life of the machine. In early years of the useful life of any machine there is always the possibility of the sudden development of structural defects and of obsolescence, inadequacy, or cessation of demand, any one of which may result in the retirement of the equipment.

Depreciation rates on identical equipment owned by different companies may vary because of different maintenance policies, even though the elements of wear and tear not covered by maintenance, and obsolescence are similar. Maintenance policies may vary physically as to the degree of efficiency at which equipment is maintained, and as to the accounting treatment of maintenance, whether as an expense or as a replacement charged to the reserve.

When repairs are made in conjunction with a larger program of improvements, care should be taken that they are adequately substantiated as such, and that invoices and other supporting data clearly distinguish between repairs and improvements. This is neces-

sary to permit proper accounting, and it will facilitate substantiation of deductions for repairs in federal income tax returns.

METHODS OF COMPUTING DEPRECIATION.—Many different methods are used in computing the estimated periodic amount expressive of the diminution in the useful life of depreciable assets. The bases of the allowance for depreciation vary in different industries and businesses and often within one business as to different items of property. Most manufacturing companies determine depreciation charges by the straight-line method, based on the estimated useful life of the plant or of appropriate groups of items. In industries such as those operating blast furnaces and coke plants periodic provisions are frequently based on a specified rate per unit of production, the amount of the provision for different fiscal periods varying in direct proportion to the fluctuation in the output of pig iron or coke. This method is sound in these industries because maximum production imposes a correspondingly heavy burden on the plant, whereas the wear and tear on equipment is appreciably less when production is light.

A list of various methods for computing depreciation includes:

Straight-line
Unit of production and hours of service
Diminishing balance
Sum of expected life periods
Interest
Appraisal
Gross operating revenue

Straight-Line Method.—The straight-line method is found most often in practice because it is usually the most feasible. Under this method, as to any given item, depreciation is provided for in equal annual amounts over the estimated service life.

The argument most often advanced against the straight-line method is that the service life of property does not in fact diminish in equal periodic amounts. For example, more than the ratable mileage life of an automobile may be consumed in the first year. This argument may be not only valid but may be controlling when but few items of property are involved. If property consists of a number of items, the probability is that the composite age of the property groups will attain and maintain a relatively fixed level after a company has been in existence for some time. Under these conditions the argument cited becomes academic.

Unit of production or hours of service methods may appear to distribute cost more reasonably than the straight-line method, but if volume falls substantially below normal, it may be necessary to adjust production costs to include further depreciation charges. When production materially affects the life of the asset, it may be preferable to use the production basis, but when depreciation is not materially affected by volume, or when the exhaustion of service life of assets cannot be related reasonably to products produced, the straight-line method is preferable.

Unit of Production and Hours of Service Methods.—Under the unit of production method depreciation is provided for in the ratio that production during a period bears to the estimated total number of units which a plant may be expected to produce during the normal service life, and is appropriate if the life span of equipment can be calculated satisfactorily in units of production. The difficulties involved in computing depreciation upon the production basis often prevent the use of this method. There are not many machines whose useful lives can be estimated accurately in terms of production units.

The hours of service method which attempts to relate loss of service life to hours of actual use of property is subject to the same limitations as the unit of production method.

Diminishing Balance Method.—Under this method a rate is determined, based on a formula which, when applied to the diminishing balance of cost, periodically determined, will reduce the initial cost to scrap value by the end of the estimated life of the items or group of items involved. The advantage claimed for this method lies in the fact that the allowance for depreciation is relatively higher during the early years of the useful life of a machine, when repairs and maintenance are usually lower, and in later years when repairs and maintenance are higher, the allowance for depreciation is lower. One disadvantage of this method is that it is very cumbersome when there are many similar items of equipment. Under such conditions, and unless the entire property is new, rates on the straight-line basis are more easily applied, and may be just as reasonable.

The error is sometimes made of applying rates computed on a straight-line basis when using the diminishing balance method. This results in failure to provide sufficient allowance during the service life of the asset. If a fixed percentage of 10 per cent applicable to an item costing $1,000 with an anticipated salvage value of $100, and intended to be applied on a straight-line basis, were applied on a

diminishing basis, an undepreciated balance of cost of $348.68 would remain at the end of the tenth year instead of $100.

Sum of Expected Life Periods Method.—Under this method, the rate of depreciation for each year varies and is determined from a fraction in which the numerator for each year represents the remaining estimated life of the plant in such year and the denominator is an amount which is obtained by adding the years of service numbered successively from one through the last year of expected service. In the case of a plant having a service life of ten years, the sum of the service years from 1 to 10 is 55 and the respective annual depreciation rates are $\frac{10}{55}$ for the first year, $\frac{9}{55}$ for the second year and so on to the tenth year when the rate would be $\frac{1}{55}$. This method has the same advantages and disadvantages as the diminishing balance method.

Interest Methods.—A characteristic of these methods is that the annual allowance for depreciation is lower in the early years of useful life of property and increases progressively in accordance with an assumed rate of interest. Interest methods are seldom used in the United States; illustrations of some of them are given in the following paragraphs.

Under the compound-interest method, sometimes referred to as the present-worth method, the annual depreciation charge is comprised of (1) the annuity which, if invested at an assumed rate of interest, will equal the cost of the property to be depreciated at the end of its service life, and (2) interest for one year on the aggregate amount of the annuities plus interest accumulated to the beginning of the year. The charge for the first year is the annuity only and the charge for each succeeding year is the annuity plus interest for one year at the assumed rate on the compound amount of the annuities at the beginning of the year. There is no difference between this method and the sinking-fund method in the amount of the reserve for depreciation which will be accumulated against a unit of property where the same rate of interest is assumed. Also, with a zero interest rate, the compound-interest method yields the same result as the straight-line method.

The sinking-fund method is based on the theory that credits to the allowance for depreciation account should correspond with the amount of money which, if set aside periodically, together with the interest earnings thereon, would equal the cost of property, less salvage, at the expiration of its service life. Ordinarily a segregated

investment fund is not established and an assumed interest rate is applied to the balance in the depreciation reserve to give effect to assumed interest earnings. For all practical purposes, this method is merely a variation of the compound-interest method. Assuming the same rate of interest, the only difference lies in the treatment of the interest component. Under the compound-interest method, interest is a component of the depreciation charge, while under the sinking-fund method, interest is treated as a separate credit to the depreciation reserve. The accounting results under both methods are identical if the interest is charged to the depreciation expense account rather than to interest expense.

Appraisal Method.—The appraisal method contemplates frequent appraisals of property and the charge for depreciation is considered to represent the difference between the appraised values of the property at the beginning and end of the period between appraisals. Aside from being an expensive way of arriving at a figure which would still be an estimate, the appraisal basis is not a very satisfactory one if the appraisers recognize only observed depreciation. Such observed depreciation seldom rises above a relatively small percentage of the cost of the equipment. If it is in excess of, say, 25 per cent, the equipment is probably in such condition that it will be necessary to retire it from service at an early date. If the allowance for depreciation is limited to the amount indicated by observed physical depreciation, it means that the burden of the loss on retirement of equipment falls in the period in which the equipment is retired. This violates the basic concept of depreciation accounting because obviously it does not fairly allocate the cost of property, plant and equipment to income over the useful service life of such assets. Deliberate allocation of a disproportionate part of the cost to the period in which the property is retired is not a sound accounting procedure.

Gross Operating Revenue Method.—The method of charging operations with an amount based upon a percentage of gross operating revenue to cover depreciation seldom considers whether the result will be sufficient to absorb the cost of property over its service life. It is usually not contemplated that the percentage will be increased if gross revenues do not come up to expectations. The result is that depreciation due to deterioration and obsolescence, which continues in periods of declining revenues, is not absorbed in costs of those periods. In the past, the method has been widely used by public utility companies. The amount computed is usually considered

to cover both depreciation and maintenance and is divided between maintenance, which is determined from actual expenditures, and provision for depreciation, which is determined by deducting the amount of the actual expenditures for maintenance from the total charge fixed at a percentage of gross operating revenue. It is obvious that extreme fluctuations in the provision for depreciation may result from period to period when this method is used.

Land.—Under normal conditions it is considered that land does not depreciate. It is now recognized that arable land in the United States depreciates through use. Land on which buildings are erected or which is used for storage and other purposes may not depreciate, but the auditor must inquire into the purpose for which the land is held or used, its location and other factors before he can decide whether the land has depreciated.

Construction Work in Progress.—Many concerns clear all charges for new equipment and construction through a work-in-progress account. Upon completion of installation or construction, accumulated costs are transferred to the appropriate asset accounts. Ordinarily no depreciation is computed on uncompleted construction inasmuch as depreciation for accounting purposes is assumed to begin when the unit or property under construction is available for operating use.

Purchased Plant.—Acquired properties are ordinarily recorded at cost price. Under the accounting prescribed for utility companies, property is generally required to be stated at its original cost to the person first devoting it to public service, and the difference between this original cost and cost to the purchaser is included in a separate account to be disposed of according to commission regulations. With this exception, it is not usual to record the former owner's cost and the related allowance for depreciation, as these amounts have no significance to the purchaser. Since a portion of the service life of such property has expired, careful consideration should be given to the estimate of its remaining useful life.

Improvements to Leased Property.—Department stores, hotels, theatres and office buildings often are erected on land which is leased for a definite term of years and tenants may make extensive improvements to leased buildings. The general rule to be followed by lessees is to amortize the cost of improvements to leased property over the life of the lease or to depreciate them over the useful life of the improvement, whichever is shorter.

For depreciation purposes the life of a lease is its original term, without regard to options to renew unless and until they are actually exercised. With a lease for an original term of ten years with an option to renew for an additional five years, the possibility that the option to renew may be exercised does not make the lease a fifteen-year lease, and, until such time as the option is actually exercised, the lease is for ten years only. When the lessee elects to exercise the option, any unamortized portion of improvements should be distributed over the period between the date the option is exercised and the extended expiration date of the lease, or over the remaining useful life of the improvements, whichever is the shorter.

When a lease requires the restoration of the premises to their original condition, reasonable wear and tear excepted, the estimated expenses of such restoration should be spread over the term of the lease.

Depreciation in Federal Income Tax Returns.—Depreciation accounting has been and probably will continue to be influenced by decisions of the federal taxing authorities. Various regulations governing depreciation accounting for tax purposes have led many businessmen to adopt the tax method to avoid the necessity of two sets of records. The principles set forth in the preamble of Bulletin "F" prepared by the Bureau of Internal Revenue agree with generally accepted accounting principles; therefore, there ordinarily should be little difference between depreciation for accounting purposes and depreciation for taxation. However, while the principles are the same, there have been many differences of opinion between taxpayers and the Bureau of Internal Revenue as to the proper rates of depreciation to be used in computing the allowance for depreciation. This is understandable as the businessman must be prudent in providing for losses, while the Bureau usually seeks to allow the minimum amount.

While the principles employed by both accountants and taxing authorities are approximately the same, tax bases and methods need not, and in many cases should not, be adopted for reporting financial condition or the results of operations to others than taxing authorities. The books of account and financial statements prepared by company management should reflect as fairly as possible the existing conditions, and should not be distorted by application of tax rulings which are not pertinent in the circumstances.

Replacement Accounting.—Under the replacement method of accounting, no depreciation is charged to operations and no charge

is made for exhaustion of service life of property, plant and equipment until such assets are replaced. Under this method, when property is replaced, the cost of the replacement rather than the cost of the property retired from service is charged to operations unless the replacement not only replaces but also improves the old property. If the old property is improved, the portion of the new cost which can be construed as the cost of the betterment is charged to the property account. When property is retired without replacement, the original cost logically should be charged to expense, but under the replacement method of accounting this is not required.

Replacements of property are seldom made in a uniform pattern from year to year; profits may vary substantially depending on management's judgment as to what plant and equipment needs replacement in a particular period. There may be instances in which large properties are composed of a number of small units, so that annual replacements may approximate the amount of an annual allowance for depreciation; even in these instances, the authors do not believe that replacement accounting is an acceptable substitute for depreciation accounting.

Retirement Reserve Accounting.—The retirement reserve method of accounting is similar to the replacement method in that it is not a means of determining depreciation but is a procedure that is sometimes used in lieu of depreciation accounting. Under the retirement reserve method formerly used by many public utility companies, provisions and allowances are not intended to reflect in any way the estimated exhaustion of useful life. The retirement reserve method is based upon the assumption that it is unnecessary to charge to operations the cost of property, plant and equipment during the period of their useful life. Its objective is the equalization of charges to income for retirement costs during an assumed perpetual life.

Under the retirement reserve method, it is usually considered desirable to provide at least sufficient reserve to cover immediately expected retirements. The periodic provision for retirements may be based on a percentage of gross revenues; a combined provision for both maintenance and retirements may be based on a percentage of gross revenues, and the amount credited to the reserve for retirements is the total provision less actual maintenance expenditures. Sometimes companies make round-sum provisions for retirements. In some instances retirement reserves have been augmented by direct charges to surplus. It seems obvious that retirement accounting is not depreciation accounting. Although the practical result of both

methods is to reduce the book value of assets in use, the intent, the theories, and the final effect of the application of the two methods are at variance.

Retirement reserve accounting was formerly required or permitted for many electric and gas utilities by uniform systems of accounting prescribed by various federal and state regulatory commissions. The systems of accounts adopted by most state and federal utility regulatory bodies now provide for depreciation accounting and retirement reserve accounting is disappearing from general use by public utility companies.

When called upon for an opinion and report upon the financial statements of a public utility or other concern using the retirement reserve method, the accountant must consider the necessity of qualifying his opinion if the retirement reserves appear to be materially inadequate when compared with the amount which would have been accumulated as an allowance under depreciation accounting.

Depletion.

General Principle.—The basic concept of depletion is the absorption of investment in natural resources through amortization of its cost by charges to operations over the period during which the quantities or units of such resources are extracted or exhausted.

Allowances for depreciation and depletion spread the cost of property, plant and equipment over the useful life of these assets. An allowance for depreciation is identified with the amortization of cost of productive facilities, but an allowance for depletion is identified with the amortization of cost of natural resources. Enterprises dealing in natural resources—depletable assets—employ both depreciable and depletable assets, but the products sold by such enterprises contain physical units of only the depletable assets.

When plant and equipment remain idle, depreciation not only continues, but may be accelerated. Cessation of operations does not ordinarily affect the units of natural resources since they remain to be extracted in the future.

Obsolescence affects with equal force both idle equipment and equipment in use. Although obsolescence of natural resources sometimes occurs, it is relatively rare.

Omission of Allowance for Depletion.—Some companies engaged in the metal, timber, oil and other extractive industries omit depletion allowances from their financial statements. In support of the practice they contend that it is impossible to obtain information sufficiently accurate for use as a basis upon which to calculate depletion, and

therefore any allowance would be arbitrary and possibly misleading. They further contend that an allowance for depletion is of no importance because investors in an extractive enterprise expect the management to extract and sell its depletable assets as efficiently and economically as possible and to distribute to the investors the amounts realized from such extraction. The corporation laws of some states permit extractive industries to determine income available for dividends without giving effect to a provision for depletion.

Available information regarding future prospects varies greatly in different mines. Many of the world's large mines were extensively developed prior to the beginning of extraction operations because development was necessary to be assured of sufficient quantities of ore to justify investments in costly installations of mining equipment, power plants, railroad lines and other facilities. In smaller properties, however, frequently no more than a few years' supply of mineral is actually developed in advance of extraction. In some types of mines, it would be unreasonably expensive to perform the work necessary to estimate with reasonable accuracy the total units contained in mineral properties. Probable and possible mineral contents may be indicated, but frequently definite assurance of additional commercial ore is sought only as extraction progresses.

After preliminary development ceases and commercial operations begin, extraction and development proceed together. It has been contended that when subsequent development work indicates that the quantity of assured ore approximately equals the quantity in sight at beginning of commercial operations, charging the cost of such development to operations eliminates the necessity for depletion charges.

Other companies provide for depletion of wasting assets and argue in support of their position as follows:

1. While it is recognized generally that often it is impossible to make exact provision for current depletion, nevertheless the determination of provisions based on the best available current information is preferable to lack of any provision in the accounts.
2. There can be little criticism of a company which determines depletion provisions and allowances upon the basis of the best available information, even if the rates have to be adjusted more or less frequently.
3. Most of the major wasting-asset companies of the United States do not distribute to their shareholders all of their income realized in cash, but retain cash for the purposes of financing,

exploring, investigating and acquiring new properties. Investors in such major companies are quite content to allow managements to invest asset realizations in new properties, rather than to distribute liquidating dividends.

4. While it is probably true that investors in closely held wasting-asset companies are not greatly concerned whether depletion provisions are deducted in arriving at distributable income, the ordinary investor not closely associated with management may be confused and misled by financial statements in which no consideration is given to depletion.

Most companies in the oil industry recognize depletion and make provisions for it in arriving at net income. In nonferrous metal companies, however, there appears to be a sharp division of opinion, but the trend seems to be to include provisions and allowances for depletion. The authors believe that allowances should be made for depletion of the book amounts of natural resources through charges to income.

Basis of Depletion.—Ordinarily the basis for depletion is cost. When the assets have been revalued, the amounts resulting from such revaluation form the basis for depletion.

Methods of Computing Depletion.—The method most widely used in computing depletion for accounting purposes is based upon production or output. For income tax purposes, the percentage depletion method, because of tax advantage, is widely followed.

Production Method.—Under the production method, the depletion rate may be determined in relation to mineral reserves actually assured, that is, "blocked out" or "in sight," or in relation not only to such assured reserves but also to "probable" and "possible" reserves. Under the former procedure, the annual depletion rate is determined by dividing the unamortized cost at the beginning of the year by the units of mineral in sight at the end of the year plus the units extracted during the year. If the development work performed as extraction proceeds continues to be successful, this method will result in higher depletion charges in the earlier years of the mine life than in later years. When "probable" or "possible" minerals are included in the depletion computations, the depletion rate may remain unchanged for a number of years or until conditions dictate the necessity for a change. If estimates of "probable" or "possible" ores prove to have been optimistic, depletion allowances will have been inadequate. Depletion allowances should not be based upon "probable"

or "possible" minerals unless their existence is indicated to a high degree of probability by competent geological or other evidence.

Percentage Method.—Under the percentage depletion provisions of the Internal Revenue Code and Regulations, depletion is computed on the basis of a fixed percentage of gross income from the property, limited by a fixed percentage of net income from the property. At present, these percentages are from 5 to 27½ per cent of gross income and 50 per cent of net income.

Development Costs.—Up to commencement of commercial operations, development costs are ordinarily not charged against operations but are included in the mine property account, or recorded in a separate account. If depletion is recognized in the accounts, the deferred development costs are usually amortized simultaneously with mine cost.

The tests applied in determining when the mine has passed from a development to a producing status for federal income tax purposes are reasonable. For income tax purposes, it is considered that the producing status is reached when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional ores for mining.

Mining Properties.—If the quantity of metal contained in a property could be definitely determined upon its acquisition, an exact ratable portion of the property cost could be allocated to each unit extracted and sold. Under such circumstances, the accumulated allowance for depletion at any date would represent the precise portion of the original property cost applicable to units extracted. But because of the difficulties in estimating the mineral contents of a property, the depletion charge can only be based on an estimate of the approximate unit cost of these assets. Ordinarily the exact unit rate of depletion is not determinable at the inception of a mining venture. However, a reasonable and consistent basis for the computation of depletion usually can be found.

Theoretically, a mining property has been partly depleted whenever any mineral has been extracted. In practice, however, depletion may be recognized first at any one of a number of different points between the extraction of ore and the sale of the mine product. Depletion is variously computed upon tons of ore mined, tons of ore milled, tons of concentrate produced, or units of metal sold.

Depletion may be computed on the unit of metal, such as the pound of copper or ounce of gold, or upon the mining unit such as the ton of ore. Since the unit paid for in the production sold is usually not the ton of ore but rather the pound or ounce of metal contained therein and since the percentage of metal contained in ores in different sections of a mine may vary widely, depletion rates applied to units of metal would seem to produce more equitable results. Obviously, since value is inherent only in the metal, the prices at which mining properties are bought and sold depend not upon the tons of ore but rather upon the quantities of metal. Accordingly, if depletion is determined on the basis of tons of ore the same charge will be made with respect to a ton of high grade as to a ton of low grade with a resulting distortion of profits.

The above discussion of depletion is primarily concerned with the problems encountered by enterprises mining gold, silver, copper, or other metals. However, the reader should recognize that the fundamental concepts apply with equal force to depletion of properties containing other types of depletable assets, such as asbestos, mica, salt, marble or coal.

Oil and Gas Resources.—As stated in the preceding chapter, no one can predict accurately what the commercially useful life of any oil well will be. Ordinarily the probable reserves of oil or gas are estimated by geologists.

When production is obtained, depletion of development and depreciation of equipment costs should be computed at rates per unit of production applied to the costs. These rates should be determined by dividing the costs to be depleted or depreciated by the expected production estimated by geologists.

Timber and Timberlands.—Just as the extraction of mineral deposits depletes a mine, so the cutting of timber depletes timberlands. It is obvious that there should be written off each year that proportion of the cost of the timber as the quantity of timber cut during the year bears to the quantity standing on the entire tract at the time of its purchase. Allowance for the value, if any, of the cut-over lands should be made in determining the amount which should be charged off for depletion.

Since it is easier to determine with certainty the total quantity of timber standing on a tract of land than it is to determine the contents of a mine, it follows that the depletion (stumpage) charge can be more accurately arrived at than can depletion charges in mining operations.

In recent years considerable attention has been given to accretion in value of timberlands resulting from natural growth. It has been pointed out that many industries dependent upon wood have found it desirable to operate timberlands on a permanent basis. While there is merit to giving accounting recognition to accretion, in practice it is seldom done. When sums are spent in clearing up and reseeding cut-over lands to insure second growth, it seems logical to capitalize such expenditures and to deplete them when cutting begins.

INTERNAL CONTROL

All companies should have clearly defined policies governing their accounting for retirement and replacement of property, plant and equipment, and for maintenance and repairs. These policies necessarily affect their depreciation and depletion accounting policies. For this reason internal control of depreciation and depletion accounting is closely related to internal control of related property and maintenance accounts. When auxiliary depreciation and depletion records are maintained, the amounts shown therein for the current provision and the accumulated allowance should be balanced periodically with the general ledger control accounts. In addition, reconciliations of transactions recorded in the accounts for allowances for depreciation and depletion should be effected with transactions recorded in other accounts. Thus, debits recorded in the allowance accounts should be reconciled with credits made to property, plant and equipment accounts; and credits recorded in the allowance accounts should be matched with charges to appropriate expense or cost accounts.

At the end of the accounting period it is customary to prepare summaries of transactions recorded in allowance accounts. Ordinarily, these summaries are prepared in comparative form which adds materially to their usefulness.

AUDITING PROCEDURES

Auditor's Responsibility.—With reference to provisions and allowances for depreciation and depletion, the auditor's responsibility lies in ascertaining that the current and accumulated provisions or allowances appear to have been made in accordance with generally accepted accounting practice and principles. When provisions or allowances appear to be inadequate or unreasonable, or if the principles of depreciation or depletion accounting have not been consist-

ently followed, it is the auditor's responsibility to state the facts clearly in his report and to take exceptions if the principles or practices followed do not result in a fair and consistent presentation of earnings and financial positions.

Composition of Allowance Accounts for Depreciation and Depletion.—The auditor's procedures in the examination of the allowance accounts for depreciation and depletion will be governed to a great extent by the period covered in his audit. In his first examination of the accounts, he should attempt to obtain summary analyses showing the annual changes in the allowance accounts from the date of organization of the business to the beginning of the period for which he has been engaged to audit. Investigations and analyses previously made by a company in connection with registration statements or reports filed with the Securities and Exchange Commission or in determining invested capital for excess profits tax purposes are helpful and should be availed of in order to facilitate the work of investigating the earlier periods of the allowance accounts. This first examination usually can be confined to the larger amounts in the ledger accounts, supplemented by reference to journal entries, without inspection of supporting vouchers. When the business has a long history prior to his first audit, the auditor will find it necessary to exercise judgment and discretion in determining how far it is necessary or desirable to examine the composition of the allowance accounts as they appear on the books at the beginning of the period of his first audit.

Examination of Accounts.—An important task of the auditor in examining the property, plant and equipment accounts is to satisfy himself that the basis for depreciating or depleting such assets is a reasonable one. He should attempt to determine that the basis, methods, and rates are results of intelligent application of principles of depreciation and depletion accounting to the experience of the business under examination.

Comparisons of depreciation policies of the company with those of other companies conducting similar types of business, comparison of rates in use with those advocated by various authorities or commissions and inspection of physical plant may give the auditor a clue as to possible weaknesses in a company's depreciation policy, but the information thus developed is not necessarily controlling. The useful service life of depreciable assets used under the conditions existing in the client's business may be quite different from the useful service life of similar equipment used under different condi-

tions by some other concern. If the auditor can satisfy himself that the depreciation policies are in reasonable conformity with the actual experience of the company and are based upon intelligent consideration of present conditions and future probabilities, he need go no further.

To a great extent the auditor's examinations of property, plant and equipment accounts and of depreciation and depletion allowance accounts are interdependent. Ordinarily, the charges made against allowance accounts will be substantiated by the auditor's examination of property, plant and equipment accounts. Credits or additions to allowance accounts should be substantiated on the basis of depreciation or depletion policies of the concern under audit.

The auditor should analyze the allowance accounts and satisfy himself that the entries are in accordance with accepted accounting principles. The mathematical accuracy of the transactions recorded during the period should be tested and the auditor should assure himself that the authorized depreciation and depletion policies are being followed. He should note any change in policy with respect to depreciation or depletion and arrive at an opinion regarding the propriety of such changes. The auditor should also satisfy himself that all additions to allowance accounts representing provision for depreciation on property are properly reflected in the income statement.

Property Completely Depreciated.—When property has been completely depreciated on the books and still is in use, it is possible that the annual depreciation has been computed at too high a rate or that replacements treated as current expenses should have been charged to asset accounts. If the amount involved is substantial, the auditor may, with propriety, recommend the adjustment of the accounts to reflect more nearly cost less accrued depreciation.

Excessive Depreciation.—Sometimes there may be a tendency toward excessive depreciation allowances of machinery the important parts of which can be and are renewed from time to time. If the client has provided depreciation at a rate which contemplates the charging of renewals to the accumulated allowance for depreciation, but, wishing to be conservative, has instead charged the cost of these renewals to maintenance expenses, the accumulated allowance for depreciation usually is overstated after a few years. The auditor should review the facts and, if necessary, suggest that appropriate adjustment be made.

Depreciation Deducted for Tax Purposes.—Sometimes amounts for depreciation as provided in the accounts differ mate-

rially from amounts deducted for income tax purposes. When the differences are substantial the auditor should investigate and obtain explanations of them. While amounts allowed for income tax purposes are not controlling, the auditor should give due consideration to the reasons for material differences.

Depletion.—When depletion is recognized in the accounts, the auditor should try to ascertain that the depletion method is reasonable. If the mining enterprise consistently computes depletion upon the basis of the best information available, then its procedures may be considered reasonable. There can be no serious objection to changes in depletion rates resulting from bona fide revisions in estimates of recoverable mineral, regardless of whether such revisions are made annually or less frequently.

The auditor should, if possible, receive a written statement from the geologist, mining engineer, or other responsible and informed official stating the depletion basis and giving his opinion that the current depletion rate is reasonable. Mining men are usually reluctant to commit themselves to an estimate of ore not actually proved.

Consequently, when the depletion allowance is based not only upon developed ore, but also upon estimates of probable and possible ore, the auditor may have difficulty in securing responsible written opinion of the depletion rate. It is a reasonable request and when not complied with the auditor is on notice that the depletion rate may be inadequate or excessive. If the auditor can secure no responsible written corroboration or other satisfactory evidence in support of the depletion rate, or if depletion is not allowed for in the accounts, he should take appropriate exception in his report.

In well managed timber ventures, the quantity of standing timber will have been estimated and verified (cruised) and, with this as a starting point, the auditor can estimate the depletion charge to be made. Obviously any attempt to estimate depletion based only on an examination of money values is extremely hazardous. The records should show quantities of timber as well. If they do not, the auditor should regard the records as insufficient.

Coordination of Examination with That of Related Accounts.—As previously indicated, the examination of accounts for allowances for depreciation and depletion is closely related to that of plant, property and equipment accounts. Additions to allowance accounts are based on amounts in plant asset accounts; charges to allowance accounts usually accompany credits to plant asset accounts.

In the examination of credits to allowance accounts, depreciation included in costs or expenses is substantiated. Charges to allowance accounts may be an element in determining profit or loss on disposal of plant assets.

Time of Examination.—Much of the work pertaining to transactions recorded in allowance accounts can be performed advantageously prior to the balance sheet date. The auditor may review procedures and methods, evaluate the effectiveness of internal control and, if the accounts are being examined for the first time, summarize and review transactions recorded in the accounts prior to the beginning of the period under examination.

In the event that the number of transactions recorded in the allowance accounts during the period under audit are substantial, the auditor may proceed effectively with his audit to, say, one or two months before the balance sheet date. If he follows this timing, only a minimum amount of work after the balance sheet date will be required to complete his examination of the allowance accounts.

STATEMENT PRESENTATION

General Rule for Balance Sheet.—As a general rule, allowances for depreciation should be deducted from the costs of related assets, or the total of the allowances may be shown as a deduction from the total of depreciable assets. When depletion is recognized in the accounts, the amounts for assets subject to depletion may be shown after deduction of these allowances, or the allowances may appear as deductions from the related assets.

Exception to Rule.—In accordance with presently prescribed systems of accounts, public utility companies generally have shown the allowance for depreciation on the liability side of the balance sheet, and, as to these regulated companies, this presentation has been accepted by the Securities and Exchange Commission. However, the Federal Power Commission has amended its rules, effective December 31, 1948, prescribing the form and filing of annual reports by electric utilities and licensees which are subject to the Federal Power Act. Among the changes is the requirement that, in submitting such reports, reserves for depreciation and amortization, which have previously been shown under reserves on the credit side of the balance sheet, be deducted from the plant accounts.

Representation to Reader of Balance Sheet.—The distinction between allowances for depreciation and depletion and valuation

reserves should be emphasized. There are many factors which must be considered in arriving at an amount which fairly represents the worth of assets to owners or possible purchasers. It is not intended that a reader of a balance sheet should believe that the amount shown as cost of depreciable or depletable assets, less the respective allowances, represents a realizable amount in the event of the sale of these assets. When the balance sheet shows the gross amount of plant, property and equipment, the related allowance for depreciation or depletion, and the remaining balance, it purports to convey only the following information:

1. The cost, unless otherwise indicated, of the depreciable or depletable assets owned at the balance sheet date.
2. The portion of the cost of such assets which has been absorbed by charges to operations in periods preceding the balance sheet date.
3. The remaining portion of the cost of such assets to be absorbed by charges to operations in periods after the balance sheet date.

Allowances for depreciation and depletion are not valuation reserves inasmuch as they do not attempt to indicate economic worth. They are not to be construed as liabilities of the concern on the balance sheet of which they appear. They do not constitute allocated surplus, for the amounts measure charges to income in recognition of expiration of a portion of the useful life of depreciable property or reductions in the number of depletable units.

The periodic provision for depreciation by a charge to income and a corresponding credit to allowance for depreciation does not guarantee the existence of any fund from which future replacements of property, plant and equipment may be financed. To use a simple illustration: assume that cash proceeds of $20,000 remain from sales after payment of all applicable costs and expenses but before consideration of an allowance for depreciation, and that after allowing for depreciation in the amount of $5,000 the remainder of $15,000 is distributed to stockholders. At this point, if no further transactions were entered into, $5,000 of cash would be available for replacement of property. Usually the management will have invested the $5,000 in inventories, marketable securities, or some other asset. It follows that the mere existence of an allowance for depreciation, accumulated by periodic charges to income, is not to be interpreted as indicating the ability to replace an equivalent amount of plant assets. Consid-

eration must be given to the source from which such replacements are to be financed.

Depreciation and Depletion in the Income Statement.—The desirability of disclosing the amount of depreciation included in the statement of income is discussed in Chapter 7.

When depletion is recognized in the accounts, the authors believe that the most logical method is to compute it upon the basis of extraction, charge it to production costs and thus include an appropriate amount as a component of inventory cost. However, mining companies which recognize depletion in their accounts treat depletion charges in a number of different ways. Some charge depletion directly to surplus; others charge the income account.

Depletion based upon units extracted is sometimes charged to income rather than to costs of production and consequently is not included in inventory amounts. This procedure results in charging income with depletion on quantities which differ from quantities sold. When depletion is charged on the basis of units sold rather than units extracted, this difference will not arise, but the portion of property costs applicable to inventories will remain in plant assets.

CHAPTER 14

LONG-TERM INVESTMENTS, INTANGIBLE AND CONTINGENT ASSETS

Marketable securities are considered in Chapter 9. Other investments, not readily marketable, and those held as long-term investments will be considered in this chapter. Marketable securities are often held as long-term investments by investment trusts, insurance companies, banks, and institutions, but their ready marketability distinguishes them from the investments considered in this chapter. It is to be noted that in the statements of businesses holding marketable securities as long-term investments, such as investment companies and life insurance companies, there is usually no classification of assets as current and noncurrent.

Long-term investments may be mortgage notes, investments in securities of, or long-term advances to, affiliates or related organizations, or cash surrender value of life insurance.

Intangible assets have been broadly classified by the Committee on Accounting Procedure of the American Institute of Accountants in its Accounting Research Bulletin No. 24, issued in December, 1944, as:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration).

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

The excess of a parent company's investment in the stock of a subsidiary over its equity in the fair value of the net assets of the subsidiary at the date of acquisition of the stock is sometimes shown as an intangible asset in consolidated financial statements of the parent and the subsidiary. This asset may represent intangibles of limited existence or of indefinite duration (see Chapter 21).

Contingent assets are those whose value is contingent upon the fulfillment of conditions regarded as uncertain. Most business concerns have claims which are in dispute, such as those for overpaid taxes, patent infringements, or unfulfilled contracts. While these may not be included among the assets stated in the balance sheet, they must be considered and, if significant, they should be recognized in the balance sheet.

ACCOUNTING PRINCIPLES

Mortgage Notes and Mortgages.—Mortgage notes and mortgages should be recorded at cost or, if equity is impaired by decline in value of the mortgaged property, at cost less allowance for decline. Recognized loss should be charged to profit and loss rather than to surplus.

Investments in Subsidiaries.—Investments in subsidiaries for the purpose of control are ordinarily recorded at cost. They may be carried at amounts adjusted periodically to reflect underlying net assets of the subsidiaries, but this practice, while having some logical basis, has generally fallen into disuse and is not recommended. Changes in the market price of such securities should ordinarily not affect the amounts at which they are carried; marking up of book amounts of any assets above cost is generally objectionable; it is not certain that the investment has actually increased or decreased to the extent of the pro rata share of the change in the subsidiaries' under-

lying net assets; and it is not the function of the accounts and statements of the parent to show profits and losses of affiliated enterprises as a whole. The practice of adjusting investment accounts to reflect underlying net assets of subsidiaries is less objectionable when the subsidiaries are primarily operating divisions of the parent. The adjustment to reflect underlying net assets, if made, should be identified as a separate item in the statement of income or earned surplus of the parent company.

If investments in subsidiaries are carried at cost, book amounts must be reduced by dividends from acquisition surplus or from capital. When subsidiaries have sustained substantial losses since dates of acquisition and the parent company's investment has been impaired, consideration should be given to writing down the investment on the parent company's books, particularly if the losses are not offset by undistributed profits of other subsidiaries. Even though the investment account be not written down because of subsidiaries' losses, any subsequent dividends from these subsidiaries should be credited to the investment account by the parent until the investment account has been written down to the extent of the parent company's equity in the net loss of the subsidiary.

Consolidated financial statements are considered in detail in Chapter 21.

Bonds, Notes, and Mortgages of Subsidiaries.—Bonds, notes, and mortgages of subsidiaries should be recorded at cost unless circumstances such as default of interest or principal indicate the desirability of a write-down.

Cash Surrender Value of Life Insurance.—Cash surrender value of life insurance should be recorded at amounts determined from tables in insurance policies and confirmed by insurance companies. Recorded amounts may include accrued dividends due from mutual insurance companies and additional cash surrender value acquired by application of dividends left on deposit with the insurer.

Intangible Assets.—Accounting for intangible assets is considered in Accounting Research Bulletin No. 24 of the American Institute of Accountants. Intangible assets of limited existence may be recorded at cost which should be amortized over the life of the asset; intangible assets of indefinite duration may be recorded at cost unless a decrease in value indicates a write-down or write-off by charges to income or earned surplus; or all intangible assets may be carried at nominal amount. Cost of noncash acquisitions may be determined

either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

Patents.—Cost of patents may include expenditures for government fees, attorneys' fees and expenses, and expenditures for experimentation and development. The cost of developing a patent may be capitalized or charged off as current expense. Frequently it is difficult to determine at the time which course to pursue. It may be obvious, after a period, that the experiments under way are not yielding satisfactory results; then the cost is clearly an expense. More often the result is doubtful and then it is permissible to elect whether to capitalize or charge off the account. If a patent application is denied, the accumulated costs should be charged to expense. Legal and other expenses of patent application or interference suits may be deferred until a decision is rendered. If a patent applicant is successful in an interference proceeding in the Patent Office, the expenses of the proceeding should be considered as patent application cost.

Expenditures for unsuccessfully defending or prosecuting patent infringement suits should be charged to expense when incurred unless such expenses clearly add to the value of the patent. If value is added, costs may be capitalized to the extent of the clear increase in value.

It is sometimes necessary to determine the cash value of patents which have been acquired in exchange for capital stock. If at the time there is a free and active market for the shares, it seems evident that willing buyers and sellers themselves are fixing a fair price for the patents. When the market for the shares is not active other evidence must be sought to support a valuation. Valuation may be determined by the amount of a bona fide cash offer to purchase the patent by a financially responsible person, by capitalization of royalties obtained from the patent, or by capitalization of other earnings strictly attributable to it. The auditor should review the data supporting any such valuation to determine whether the method seems to him to be reasonable.

Expenditures for additional patents, including improvements in basic patents, may be capitalized and amortized over the useful life of the new patents. The cost of patents should not be written up, even though the value appears to be much in excess of cost. If several patents are acquired for a lump sum and it is impossible to assign separate cost to each patent, computation of annual amortization should be on the group as a unit, giving consideration to the expiration dates of the various patents.

Patents are granted in this country for a term of seventeen years. The cost may be distributed pro rata over this period or over the period between the date of application and the date of expiration. The cost of patents of no commercial value should be written off immediately.

Usually the period over which the cost of a patent is to be written off cannot be known until the patent is granted for there is no way of knowing how much time will elapse between the date of application and the date of granting. The argument is often advanced that there is no necessity for writing off any portion of the patent until the actual granting of the patent. This procedure makes unnecessary any retroactive adjustment upon the granting of a patent. The practical consideration, however, is really the only argument to be made for this procedure and in principle the spreading of the cost over the entire period between application for and expiration of a patent is the more equitable method.

Some companies amortize patent costs over a twenty-year period beginning at the application date on the theory that on the average three years elapse between date of application and date of issue of letters patent. If the three-year period can be substantiated by the client's actual experience there is no objection to this practical solution of the problem. When the patent is granted, the remaining cost should be spread over seventeen years; if and when the application is not granted, the remaining cost should be charged off.

Patents should be reviewed periodically and when value has disappeared because of obsolescence or for some other reason, the amortized costs should be written off.

Patent development costs are frequently charged to expense as they are incurred, particularly by businesses with research departments continually experimenting with new developments. The cost of a patent usually bears no relation to what it does or should earn and is often wholly nominal in amount.

Trade-Marks, Brands, and Trade Names.—Trade-marks, brands, and trade names should be recorded at cost which includes attorneys' fees, registration fees, and other expenditures definitely identifiable with their acquisition. The determination of that portion of advertising cost that may be treated as a cost of developing trade-marks and trade names and consequently a capital expenditure is usually so difficult that all such items should be treated as current expenses. Some companies have capitalized their advertising expenditures only to find upon the cessation or reduction of their adver-

tising that the drawing power of a trade-mark or trade name has to be constantly nourished. What they had been capitalizing was, in fact, maintenance.

Under federal statute, trade-marks and trade names may be registered for a period of twenty years and may be renewed indefinitely for additional like periods. They may be registered also under the laws of most states and in some states there is no time limit on the effectiveness of the registration. However, there is a significant distinction between patents and copyrights, and trade-marks and trade names. The right to a patent or copyright arises from registration under the statute; the right to a trade-mark or trade name is a common-law right based on its usage. It is customary, therefore, to consider trade-marks or trade names as being of value as long as they are used. Usually they are carried at cost less any amortization written off. The basis of amortization, if any, is usually arbitrarily selected.

Copyrights.—Cost of copyrights may include expenditures for government fees and attorneys' fees and expenses. Many of the considerations which apply to patents apply also to copyrights. The term of a copyright is twenty-eight years and in certain circumstances it may be extended for another twenty-eight years. Most copyrights diminish in value irregularly and amortization usually should be based on periodic revaluations of each copyright rather than on life.

Royalty and License Contracts and Franchises.—Royalty and license contracts granted under patents and copyrights are not usually given financial recognition in the accounts of the person to whom the rights are granted. Fees of attorneys drafting the contracts may be capitalized, but in practice minor amounts are charged to expense. When royalty and license agreements have been assigned for a consideration, the cost of obtaining the assignment may be capitalized.

Royalty and license contracts capitalized should be amortized over the life of the agreement or over the expected period of utility, whichever is shorter.

Cash value of franchises acquired in exchange for capital stock may be reviewed by methods described for reviewing the cash value of patents similarly acquired. Franchises should be amortized over the period of their duration.

Goodwill.—Goodwill on a balance sheet usually represents the value attached to the business at some prior date over and above

the value attributed to other stated assets. It is almost exclusively related to the ability of an organization to produce a higher than normal rate of return on the amount of the tangible assets of the enterprise.

A losing business usually does not possess goodwill unless there are obvious signs of mismanagement. The basic element of goodwill value is the probability that customers will continue to buy a specific product, at a particular place, or from the successors of those who have gained the confidence of the public. When the earnings, the confidence, and other factors of the past cannot be transferred, goodwill has little value.

The purchaser of goodwill is more interested in the future than in the past. Past earnings are of interest as indicating what has been done, but in the mind of the purchaser they are important as an indication of possible future earnings. Unprofitable companies have been sold on a basis of gross earnings, the buyers expecting to reduce expenses sufficiently to turn operating losses into net profits. However, goodwill attaches only to a business which is believed to possess possibilities of being made profitable.

Lists of subscribers to newspapers and magazines or of customers of dairies, bakeries, and laundries have business value although the enterprises themselves may not be profitable. This value is based on the estimated cash cost of securing customers.

Goodwill may be recorded at cost even though its value varies with earnings. In general, only purchased goodwill is recognized in the accounts. The ultimate determination of any change in value may be deferred until sale of the business. It might be claimed, and rightly, that purchases of a substantial number of shares of capital stock at a price above the book value are the best evidence of the value placed upon goodwill by disinterested persons. This might be true in a particular case, but there is so much uncertainty surrounding any attempt to determine the value of goodwill that by common consent it is usually not revalued.

Many new businesses require several years to become firmly established. Net operating losses in these first few years have frequently been capitalized as goodwill on the theory that operating expenses in excess of income were in reality development expenditures essential to the establishment of a steady patronage and the good name of the concern. In general, this practice should be condemned. If specific expenditures can be identified with building future business and prestige, it is permissible to treat them, at least in some measure, as deferred charges. To capitalize net losses arbitrarily as goodwill,

even during the initial stages of an enterprise, usually is misleading.

Occasionally it is necessary to determine the value of goodwill. When a business is sold, both the seller and the buyer may want to determine a reasonable value for goodwill. When a business established prior to March 1, 1913, is sold, the value of the business at that date must be determined to arrive at the profit on the sale for federal income tax purposes and this value may include goodwill.

As has been indicated, the value of goodwill is predicated on earning power, and the courts, particularly the Tax Court of the United States, have resorted to a formula under which, after allowing for a fair return on tangible assets employed in the business, any excess of average annual earnings over a representative period of years (usually five, but sometimes as many as ten) is capitalized at a suitable rate of return. In a number of cases involving the determination of goodwill for invested capital purposes under the Excess Profits Tax, or for federal income tax purposes, rates of 8 and 15 per cent on tangible capital and intangible capital, respectively, were used for established industrial or mercantile enterprises.

When a company acquires the stock of a subsidiary at a price in excess of capital stock and surplus as recorded on the subsidiaries' books, this excess may represent goodwill to be stated separately in consolidation. This is discussed at some length in Chapter 21.

Goodwill does not suffer wear and tear, does not become obsolete in the usual sense and is not used up in the operations of business; therefore it is not necessarily subject to periodic amortization. If amortized, the basis necessarily will be entirely arbitrary and if written off, a secret reserve may be created. Some accountants believe, therefore, that no objection should be offered to its continued reflection at cost, but there are also those who believe otherwise. Reasonable discretionary amortization, even when there is no evidence of loss of value, is certainly permissible, even though not mandatory. The position of the Committee on Accounting Procedure of the American Institute of Accountants is set forth in the following excerpt:[1]

> If a corporation decides to amortize the cost of (an) intangible, as to which there is no present indication of limited existence or loss of value, by systematic charges in the income statement, such procedure is permissible despite the fact that expenditures are being made to maintain its value. The plan of amortization should be reasonable; it

[1] American Institute of Accountants, Accounting Research Bulletin No. 24, issued in December, 1944, p. 199.

> should be based on all the surrounding circumstances including the basic nature of the intangible and the expenditures being currently made for development, experimentation, and sales promotion. . . . . The procedure should be formally approved, preferably by action of the stockholders, and should be fully disclosed in the financial statements. The committee believes that such amortization should be entirely within the discretion of the corporation and should not be regarded as mandatory.

The position of the Securities and Exchange Commission is indicated in the following quotation:[2]

> The Commission has adopted no general rule as to the amortization of goodwill. However, in those cases in which a registrant has retained "goodwill" indefinitely in its accounts, the staff has inquired into the propriety of this accounting treatment. As a result of an analysis of the nature of the account a number of registrants have undertaken programs of amortization which will result in charging the goodwill to income or, in some cases, earned surplus, over a reasonable number of years.

Amortization of goodwill should be charged to profit and loss or, if material in amount, to earned surplus. A write-off of goodwill with undisputed continuing value to capital surplus is occasionally justified, but as and when it becomes evident that the goodwill has lost its value, a charge should be made to earned surplus for the loss then sustained with a corresponding credit to capital surplus to restore the amount of the earlier charge thereto. The Securities and Exchange Commission holds that a write-off of goodwill to capital surplus is contrary to sound accounting principles, possibly because the adjustment between earned and capital surplus when the loss of goodwill becomes evident might be overlooked, preferring the conservative understatement of earned surplus and the corresponding overstatement of capital surplus during the period in which the goodwill continues to have a value equal to cost.

Tax Refund Claims.—Tax refund claims, usually with a contra allowance account, should be booked so that they will not be overlooked during the interval between the filing of the claims and their subsequent allowance or rejection and to call attention to the running of the statute of limitations and the necessity for instituting suit if the limitation date is imminent.

[2] William W. Werntz and Edmund B. Rickard, "Requirements of the Securities and Exchange Commission," in Thomas W. Leland, ed., *Contemporary Accounting,* American Institute of Accountants, 1945, Ch. 38, p. 5.

INTERNAL CONTROL

Suggestions for internal control of marketable securities included in Chapter 9 apply to long-term investments as well. Intangible and contingent assets, because of their inherent characteristics, are subject to little internal control beyond obtaining proper authorizations for capitalizations, amortizations, and write-offs.

AUDITING PROCEDURES

Objectives.—The auditor's responsibility for long-term investments is similar to that for marketable securities. He should satisfy himself that they are actually the property of the company and that they are stated at reasonable amounts under generally accepted accounting principles. Reasonable amounts for cash surrender value of life insurance are those computed as realizable; for other long-term investments they are usually not in excess of cost or cost adjusted to reflect any decline in value believed to be permanent.

The auditor's consideration of intangible assets is usually influenced by his desire for conservatism. The absence from a balance sheet of any indication of the existence of intangibles, even though they might normally be expected to be an important element in the concern's success, causes little or no comment, but their inclusion on a balance sheet at any amount higher than a nominal one is usually not an attempt to give expression to their current value.

The auditor must not neglect these assets merely because they are intangible. In his examination he should determine that both the gross amount and the provision for amortization, if any, are stated in accordance with accepted accounting principles.

Examination of Mortgage Notes and Mortgages.—The auditor should examine both mortgage notes and the mortgages supporting them. He should determine that the client is designated as payee and mortgagee or that the note and mortgage have been assigned to him. He should inquire whether both the mortgage and the assignment have been recorded. The laws concerning mortgages vary in the various jurisdictions and, while an auditor is not expected to pass on the legal sufficiency of a mortgage, he should be familiar with the procedures, forms, and recording requirements customary in the jurisdiction in which he practices.

The amount at which the mortgage is booked should be substantiated as not in excess of cost or cost adjusted to reflect any decline in

value believed to be permanent. The auditor should make inquiry as to whether taxes or other assessments are in arrears and whether the mortgagee's interest in the property is protected by insurance. The mortgagee will frequently hold policies covering losses from fire, windstorm, and public liability, executed in his favor or assigned to him, as well as an attorney's opinion or guaranty of title. If an apparently trustworthy appraisal of recent date positively identified with the mortgaged property is available, the amount should be compared with the unpaid balance of the loan.

The auditor may find it desirable to investigate the financial responsibility of the maker and any endorsers of the notes to which the mortgage is collateral. The mortgagee should keep informed as to the general condition of all properties on which he holds mortgages and as to the circumstances affecting their values. This information may be required by the auditor if payments against principal, interest, or taxes on the mortgaged properties are in arrears or if the amounts of the loans are out of proportion to the amounts of recent appraisals. If a loss on a mortgage seems to be in prospect, the auditor should inquire whether the mortgagee is taking proper steps to protect his interests.

On occasion canceled or fictitious mortgages have been submitted as outstanding or genuine. A clever forger can manufacture documents which will deceive those more familiar with such papers than the average auditor. Although he cannot accept responsibility for discovering forgeries, the auditor should examine papers and correspondence usually accompanying mortgages and the record of the original purchase and collections of principal and income in an effort to determine that there are no obvious irregularities.

Amounts due on mortgages at the balance sheet date, if significant, should be confirmed by direct correspondence with the mortgagor. Partial payments reducing the original amount of the loan may be endorsed on the note, but this procedure is not always followed and the auditor's reliance should be placed on direct confirmation of the balance due.

Examination of Investments in Building and Loan Associations and Cooperative Banks.—Withdrawal amounts of serial shares of building and loan associations or cooperative banks should be confirmed by direct correspondence with the issuer. Unpledged shares should be substantiated, not only by correspondence, but also by examination of certificates and passbooks, for certificates and passbooks have been pledged against bank loans without advising the

issuing association. If the client claims that formal certificates have not been issued, this fact should also be confirmed by direct correspondence with the association.

Examination of Investments in Subsidiaries and Affiliates.—Stocks, bonds, notes, and mortgages of subsidiaries and affiliates should be substantiated by examination of evidences of ownership or by direct correspondence with holders of these evidences. These investments are usually held over a long period and it is customary for the auditor to record, in his permanent working papers, certificate and bond numbers and other pertinent facts relating thereto. Reference to this record when the evidences of ownership are being examined may reveal transactions otherwise unknown to the auditor. The auditor must also determine that these investments are recorded in accordance with accepted accounting principles.

Examination of Cash Surrender Value of Life Insurance.—The amount at which cash surrender value of life insurance is recorded may be approximately checked by computation from tables in the policies, and should be confirmed by direct correspondence with the insurance companies. In addition to cash surrender value the auditor should request confirmation of the beneficiary, assignments, dates to which premiums have been paid, accumulated dividends, loans made against the policies, interest prepaid or due on these loans, and any reservations of rights. If the insured has the right to borrow money on the policies or to change the beneficiary, the concern paying the premium may have no equity in the cash surrender value.

Insurance companies use different methods in computing cash surrender value at a given date. It is not necessary that the amount as computed by the client agree exactly with that confirmed by the insurance company, but the difference should not be appreciable.

Unexpired portions of premiums on life insurance are properly includible in prepaid insurance, but occasionally they are included in cash surrender value. The auditor must determine that they are not included in both accounts.

Examination of Intangible Assets.—The auditor should analyze the patent account to determine whether it contains entries that relate to other intangibles. Whether or not they are combined in one item on the balance sheet, different kinds of intangibles should be carried in separate accounts on the books.

The auditor should examine patent papers and assignments, documentary evidence of trade-marks, brands, trade names, copyrights,

royalty and license agreements, and franchises. When possible he should confirm the existence of these intangibles by direct correspondence with the client's attorneys.

Book amounts of these intangibles should be substantiated as being in accordance with accepted accounting principles. The auditor should satisfy himself that the accounting provisions of royalty and license agreements and franchises are being complied with. An opinion from the client's counsel is often desirable, particularly if there are restrictions which are legal rather than accounting.

The goodwill account should be analyzed to determine the nature of the transactions that gave rise to its recognition and the basis of the amount at which it is recorded. The auditor should determine that the book amount is stated on a basis consistent with accepted accounting principles. He should determine that both capitalization and amortization of goodwill, if any, are properly authorized by examination of minutes of meetings of stockholders and directors, partnership agreements, and other written evidence.

There have been instances in which bonus common stock was issued to subscribers to preferred stock after a company was founded and the book amount of the bonus stock was booked as goodwill. Such an item usually has nothing to do with goodwill, but is essentially a financial or organization expense that should be written off over a reasonable period. The auditor should ascertain that the goodwill account contains no such expense.

Examination of Contingent Assets.—The auditor may establish the amounts of contingent assets or the existence of contingent assets of undetermined amount by inquiry and by examination of supporting written evidence. He should inquire whether there are any uncalled capital stock installments and consider the probability of collection.

Coordination of Examination with That of Related Accounts.—In his examination of long-term investments, intangible and contingent assets the auditor may have accumulated information substantiating in whole or in part the following accounts:

- Dividends receivable from subsidiaries and from mutual life insurance companies
- Interest income and interest receivable
- Loss on long-term investments
- Life insurance expense
- Amortization or write-off of intangible assets

Time of Examination.—Many of the auditing procedures in substantiating long-term investments, intangible and contingent assets may be performed prior to the date as of which the examination is made. Acquisitions of these items up to an interim date may be substantiated during the year and those between the interim date and the year end substantiated later. Evidences of ownership of mortgage notes, mortgages, and investments in subsidiaries and affiliates may be examined prior to the year end and controlled under seal until the year end. Minutes of meetings of stockholders and directors may be examined at an interim date and the examination later brought up to the year end. Further examinations will probably have to wait until the close of the year.

STATEMENT PRESENTATION

Investments in Subsidiaries and Affiliates.—Investments in stocks, bonds, notes, long-term advances, and mortgages of subsidiaries and of affiliates and related organizations when these investments are made for purposes of control, affiliation, or other continuing business advantage should be classified on the balance sheet as noncurrent. Amounts at market quotations, if available, may also be indicated, but it is not general practice to state them. Such market quotations are less important than those for marketable securities, because there is usually no present intention of disposing of the investments. It is customary to state the basis on which the investments are carried, and to indicate the equity in underlying net assets of subsidiaries. Any subordination of notes receivable from subsidiaries or affiliates to notes payable to banks by them should be disclosed.

Cash Surrender Value of Life Insurance.—While cash surrender value of life insurance is sometimes classified as a current asset when the funds to be received on the death of the insured are unrestricted as to use by the beneficiary, classification of this asset as noncurrent is generally recommended and is supported by Accounting Research Bulletin No. 30, issued in August, 1947. The usual function of this asset is distinctly noncurrent; its purpose ordinarily is not to provide working capital, at least until the death of the insured.

Intangible Assets.—Intangible assets of limited existence and those of indefinite duration should be shown separately on the balance sheet, if practical. They are usually the last item on the balance

sheet, although they may be included with fixed assets, particularly in statements of public utilities. Segregation of intangible assets of public utilities is often impractical. The requirement of this segregation is comparatively recent, and the information necessary for such segregation may not be available. The important elements of intangibles of public utilities are often rights of way and franchises which are closely related to plant assets. In consolidated statements of public utilities the excess of amounts paid by the owning company over the underlying book amount of investment in subsidiaries is also included with plant accounts, usually as a separate item in one amount because of the impracticality of allocation to tangible and intangible assets.

The basis of the valuation of intangible assets should be indicated; cost is assumed to be the basis unless another basis is stated. The fact and basis of amortization of intangible assets, if any, should be clearly indicated.

Contingent Assets.—The disclosure of significant contingent assets in a footnote is usually preferable, but they may be shown in the assets, indented and not included in the aggregate assets, or in the assets with a contra reserve deducted from the assets or included in the liabilities. Disclosure of contingent assets in a footnote is preferred since it seems to imply less certainty regarding the probable realization of the asset than do the other two methods.

There is rarely any necessity for mentioning contingent assets, but if material in amount and there seems reasonable likelihood of their realization, failure to disclose them may result in concealing important information.

CHAPTER 15

PREPAID EXPENSES AND DEFERRED CHARGES

Prepaid expenses and deferred charges are the portions of expenditures or accruals made prior to the balance sheet date that are proper charges to income of subsequent periods. The distinction between the two, usually recognized by accountants, is that prepaid expenses represent the balance of amounts paid for services or for such items as rent and insurance, not received or the benefit of which had not been fully realized at the balance sheet date, while deferred charges represent payments for goods and services which have been received, but the income ~~against which such payments~~ are considered chargeable will accrue in the future. According to this distinction, the pro rata amount of a fire insurance premium applicable to the unexpired term is a prepaid expense, while the cost of uncompleted experimental work, which may reasonably be expected to result in income, is a deferred charge.

ACCOUNTING PRINCIPLES

Allocation of Prepaid Expenses and Deferred Charges to Periods Benefited.—It is a generally accepted accounting principle that, where practicable, expenses and costs which are charges against

earnings of more than one period should be apportioned equitably to the specific periods in which the earnings arise. In conformity with this principle, prepaid expenses representing advance payments for services yet to be rendered should be apportioned to those periods during which the services will be performed. Deferred charges, on the other hand, since they relate to services with respect to which the payee has done all that he is required to do, may or may not be properly allocable to several periods. If future periods will in fact be benefited, the period of allocation should extend up to the date at which benefit may reasonably be expected to cease.

The discussion in this chapter generally applies to a going business in which it is expected that future income will be sufficient to absorb prepaid expenses and deferred charges relating to such income. If it is expected that future income will be insufficient to absorb such expenses and charges, the general rule does not apply, and the facts and circumstances should be considered in determining what part, if any, of prepaid expenses and deferred charges should be carried forward to a subsequent period.

Good accounting practice leaves little choice as to how material items should be charged when the benefits therefrom are reasonably expected to aid or apply to subsequent periods. Expenses wholly incurred for the purpose of increasing profits of future years should be apportioned to income over the periods which they are expected to benefit.

When prepaid expenses or deferred charges have a time limit, they should be equitably apportioned over their effective life. With respect to such items as rent, interest, and insurance, this usually means that each month will bear its proportionate share of the total. When the prepaid or deferred amounts relate to production or to sales, they usually should be apportioned on the basis of units of production or units of sales. When the benefits to be derived cannot be accurately related to specific periods to production or to sales, and it is reasonably certain that future periods will profit therefrom, accepted accounting practice requires that the prepaid and deferred amounts be written off as rapidly as may seem reasonable in the circumstances, usually in equal though arbitrarily computed installments.

Deferment must not go so far as to create misleading financial statements by overstating assets and profits. Extraordinary expenditures for repairs and renewals resulting from uninsured damages from accidents or storms should not be deferred, but should be

charged off when incurred. The desire to absorb such a loss over several years is not a sound basis for carrying it as an asset.

Development expenses during the early years of a corporation are sometimes set up as deferred charges and written off over subsequent periods. This treatment may present more fairly the position of the company at a balance sheet date and the results of its operations for the period then ended than would be the case if such expenses were charged off as incurred. To charge these expenses to operations in the year incurred may be considered misleading if it can be demonstrated that benefits are to be derived from them in subsequent years.

While it may be proper to defer preliminary or establishment expenses under certain conditions, they should be charged off as they are incurred when it is doubtful that benefits will extend to subsequent periods. Many an enterprise has been wrecked by failure to recognize the point at which sound practice demands adoption of the policy of charging off such items. If they are deferred merely because of the desire to show profits from current operations, the financial position disclosed by the statements is definitely misleading. It must be remembered that liabilities cannot be liquidated with capitalized expenses. If there is agreement that some future period will be benefited, but uncertainty as to the length of time during which benefits will continue, good accounting practice sanctions such treatment as appears reasonable in the circumstances.

Annually recurring expenditures, not material in amount, may be charged to income of the period in which the expense is incurred even though the subsequent period is clearly benefited and there is no objection to this practice if it is consistently followed from year to year; for example, advertising bills for copy which is to appear in January publications may be paid and charged to expense in December.

An exception to the principle of allocating expenses and costs to the periods deriving the benefits may be observed in accounting for commissions and taxes on premiums received by fire insurance companies. It is the practice of these companies to treat commissions and taxes on premiums as expenses of the period in which they are incurred and to take premiums into income over the period of the policy. In view of the possibility of loss of many times the amount of such commissions and taxes, fire insurance companies believe there is little merit in attempting to carry forward, as assets, costs and expenses which have been incurred. The authors believe that

for fire insurance companies the charge-off of commissions and taxes on premiums to expense at the time liabilities for them are incurred is in conformity with accepted accounting practice.

Prepaid Insurance.—Premium payments to mutual insurance companies include an amount in the nature of a deposit in addition to the estimated earned premium. Dividends are computed at the expiration of the policy and the amount returnable to the insured may include these dividends as well as the deposit. These returnable amounts will be deducted from the gross premium billed by the insurance company for the succeeding period. Occasionally the amount of the deposit can be identified in statements from the insurance company; in practice identification is seldom possible. However, return premiums representing deposits and estimated dividends can be estimated for initial and subsequent periods and these return premiums should be deducted from gross premiums in computing insurance expense and prepaid insurance and should be segregated as noncurrent deposits.

Prepaid Taxes.—Prepaid property taxes are seldom actually paid in advance, for they are assessed against owners of real estate and personal property as at a certain date and usually are based upon ownership of property at that date; they may be payable months thereafter. They differ from other prepaid items in that they do not give the payer direct property rights such as a purchaser acquires when he buys supplies. Property taxes are involuntary claims on property owners which must be paid, but which produce only indirect benefits in the form of services which the taxpayer may receive from the community. Property is sometimes subject to more than one tax in the same jurisdiction; it may be taxed by the state, the county, or the township. Payment of a particular tax does not give the right of freedom from possible other taxes on the property for any period.

The preponderance of legal opinion seems to be that real and personal property taxes do not accrue, in the sense of becoming an incumbrance against the property, until the lien date; the Bureau of Internal Revenue, however, holds that, for income tax purposes, such taxes in some jurisdictions accrue on a date other than the lien date. Property taxes of each jurisdiction must be considered with reference to local laws under which they are levied.

Property taxes are prorated over the year rather than applied as a whole in the month when they are paid or assessed so that earnings in any one month will not be distorted. When a company owns

taxable property for use in its business, it is of little practical moment that the tax is based upon ownership on a particular day. That may be of importance when property is bought or sold, but when property is used continuously taxes on it are one of the expenses of doing business, not only necessary but closely predictable in amount, and therefore properly proratable over the year's business.

In actual practice, these taxes are variously treated. Accounting Research Bulletin No. 10, issued in June, 1941, indicates that they have been charged against income during each of the following periods:

- Year in which paid (cash basis)
- Year ending on assessment (or lien) date
- Year beginning with assessment (or lien) date
- Calendar or fiscal year of taxpayer prior to assessment (or lien) date
- Calendar or fiscal year of taxpayer including assessment (or lien) date
- Fiscal year of governing body levying the tax
- Year appearing on tax bill
- Calendar or fiscal year of taxpayer prior to payment date.

The bulletin states that:

> . . . . consistency of application from year to year is probably more important than the selection of any one of the periods suggested.

As a general proposition, the authors believe that the most acceptable basis of providing for property taxes is for the company to absorb such taxes on its books over the fiscal period for which they are levied by the taxing authority.

Liability for property taxes is customarily booked upon receipt of the tax bill, usually at a date subsequent to the assessment date. When the accounts of the company reflect the full liability for such taxes, either estimated or actual, and the period assigned for absorption of the tax expense extends beyond the date on which the liability was recognized, the unamortized tax expense at a balance sheet date is shown as a deferred expense and commonly called prepaid taxes.

Federal taxes on income are never prepaid, and are an expense of the period upon the income of which they are computed.

Inventory of Supplies.—Unused supplies, other than those used in manufacturing, the cost of which is a part of the cost of finished

goods, are in the nature of deferred charges, since their value is in their utility rather than in the amount that can be obtained for them. The cost of supplies such as letterheads and printed forms is often charged to expense when the supplies are purchased, but some companies prefer to charge expense as the supplies are used and then the cost of the portion unused at a balance sheet date becomes a deferred charge. Either method is sanctioned by practice.

Prepaid Commissions.—Many companies allow their salesmen drawing accounts to be applied against earned commissions. The drawing account may be in effect a minimum salary when any excess over commissions earned is charged off at the end of the year. Sometimes these excesses are carried forward as prepaid commissions to be offset by commissions earned in the subsequent period. This practice is permissible if experience has shown that these excesses are customarily offset by commissions earned. If a salesman leaves the employ of a company with a balance in his drawing account in excess of earned commissions, such balance is rarely collectible. It should be charged off as expense of the period in which the salesman leaves except to the extent of additional commissions on orders presently unfilled which later, it is expected, will be credited to his account.

Advances to Employees for Expenses.—Advances to employees for expenses are ordinarily absorbed in operations through their actual use in carrying on the business; they are usually considered prepaid expenses and distinguished from loans to employees which are accounts receivable.

Unamortized Debt Discount and Expense.—It is generally accepted accounting practice to carry as a deferred charge, usually separately stated, the amount of unamortized debt discount and expense.

Bonds are sold at a discount because the rate of interest specified in the indenture is less than the rate which the issuing corporation must pay for the use of the money. This discount is customarily charged to unamortized debt discount and written off over the period from the date of issue to the date of maturity of the bonds. The sum of the interest paid and the amortization of debt discount, by periods, should approximate the effective rate of interest on the bonds outstanding. In practice, bond discount is usually combined in the accounts with the expenses of issue.

That portion of the discount which accrues during a period of construction may be capitalized. After construction is completed, the periodic amounts of amortization are chargeable to expense.

Some large real estate operators have capitalized the entire discount on a bond or mortgage, the proceeds of which are used in the construction of buildings which they plan to sell or lease. They contend that the cost of obtaining funds for construction purposes is as much a part of the cost of the building as expenditures for more tangible items, since the building could not be erected without the financing. They claim, therefore, that the cost of obtaining funds has value throughout the life of the building and should be amortized accordingly. There is a degree of reason in this point of view, but it has not received approval of the accounting profession. The authors believe that capitalization of bond discount should be limited to that portion of it applicable to the period of construction and that apportionment to the construction period should be based upon the duration of the bond issue, not on the life of the structure.

When bonds are exchanged for property rather than sold for cash, the cost of the property may be considered to be the face amount of the bonds exchanged unless there is evidence that the market value of the bonds is less. For example, if bonds received in exchange for property are immediately sold by the recipient at less than the face amount, an amount equal to the discount suffered by the seller of the bonds ordinarily should not be included by the issuer in the cost of the property, but should be segregated as bond discount. The sale of the bonds by the recipient sets a fair value on what was given in exchange for the property.

It is good accounting practice to write off bond discount and expense over the life of the issue by periodic charges against income. In the past, debt discount and expense was often charged off to earned surplus at the date of issue, or at a later date, if the balance of surplus could absorb such a charge. This procedure, although conservative from the balance sheet point of view, relieved income of subsequent periods of a charge for discount and expense amortization. With increasing emphasis being placed on statements of income, accountants believe that such charge to surplus is inadvisable; if it has been followed it may be desirable in subsequent statements of income to disclose the effect thereon of the prior absorption of unamortized discount and expense.

When bonds sold at a discount are payable serially or subject to some agreement which provides that a portion of the issue be retired before the rest, the amounts of discount and expense written off periodically should be computed on the basis of the average length of time the bonds will be outstanding.

The straight-line basis is that most frequently used in computing

the amortization of debt discount and expense. The compound-interest method has been used in the past, but is not now frequently encountered. The straight-line method has much to recommend it. It distributes discount and expense ratably over the life of the issue or over the average life, if the issue matures serially. It is simple to compute and is convenient in that it eliminates the necessity of distinguishing between discount on an issue and the expense thereof, a distinction that must be made when the compound-interest method is used.

When bonds are retired before maturity and the debt is not refunded, the balance of unamortized discount and expense should be written off. Such write-off is usually to the income account, but the opinion expressed in Accounting Research Bulletin No. 32, issued in December, 1947, is that the charge should be to earned surplus if the amount is materially significant in relation to the company's net income and the charge to income would impair the significance of net income so that misleading inferences might be drawn therefrom.

Accounting for unamortized discount, expense and redemption premium on bonds refunded (hereinafter referred to as unamortized discount) has been considered in Accounting Research Bulletin No. 2, issued in September, 1939, supplemented by No. 18, issued in December, 1942. There are three methods of disposing of the unamortized balance. It may be:

1. Charged against income or earned surplus;
2. Amortized over the remainder of the original life of the issue retired; or
3. Amortized over the life of the new issue.

Under the first method, a charge to earned surplus is permissible only if a charge to income would produce a distortion of net income and permit misleading inferences; the charge is usually against income. Where any write-off is made through earned surplus, it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise and there should be shown as a deduction in the income statement for the year of refunding an amount at least equal to such reduction in current taxes. This treatment considers the write-off of unamortized discount as a payment for the privilege of terminating a contract which has become unprofitable. Under it, corporate accounting conforms with tax accounting, for the tax laws allow unamortized discount as a deduction in the year in which the refunding takes place, and only in that year. The resulting charge to income or earned

surplus may occasionally exhaust the available earned surplus and produce results that are inequitable, but in general this method finds more support in legal decisions, commission regulations, and accounting practice than any other method.

Amortization of the balance of unamortized discount over the original life of the issue retired has considerable support in accounting theory and is permissible; provided that the maximum balance that should be carried forward is an amount, the amortization of which will not make the annual charge for interest and amortization, on both the old and new issues, exceed the charge that would have existed had the refunding not taken place. This method conforms with the trend of opinion toward procedures which emphasize the income account rather than the balance sheet and which bring costs into the income account of some year or years under the appropriate heading rather than charging them to surplus. Objections to it are that it results in a balance sheet that is not as conservative as is desirable and the cost of retirement is more correctly regarded as the cost of terminating an agreement which has become disadvantageous than as a part of the cost of making a more advantageous arrangement for the unexpired term of the old agreement. When it is used, there should be deducted in the income statement of the year of refunding an amount equal to the reduction in the current income tax resulting from treatment of unamortized debt discount as a tax deduction, and only the remaining balance should be treated as a portion of the cost which is to be apportioned over future periods.

Amortization over the life of the new issue is the least desirable of the three methods and is permissible only when authorized or prescribed by a regulatory body to whose jurisdiction the accounting corporation is subject or when the practice has been adopted prior to the publication of Accounting Research Bulletin No. 2, September, 1939. There is little justification for distributing this expense over a period extending beyond the termination of the life of the original issue. When this method is used, a charge should be made in the income statement in the year of refunding equal to the reduction of current income taxes resulting from treatment of unamortized debt discount as a tax deduction and only the remaining balance distributed over future periods.

A compromise between the first two methods is sometimes effected by spreading the unamortized discount over a period subsequent to refunding which is shorter than the unexpired term of the refunded issue. This acceleration of amortization is permissible provided that the charges are made against income and the annual charge for inter-

est and amortization, on both the old and the new issues, does not exceed the charge that would have existed had the refunding not taken place. The unamortized balance to be distributed over subsequent periods should be reduced by the amount of the current income tax reduction resulting from treatment of unamortized debt discount as a tax deduction in the year of refunding.

Experimental and Development Expense.—Experimental and development work is initiated with the expectation that future benefits will result and, if results were always as originally planned, there would be no question that the total costs should be spread over the periods benefited by the work undertaken. The only problem would be to estimate at the outset the period to be covered by the amortization. In practice, however, much experimental and development work, undertaken in good faith, fails to produce the results anticipated; when it becomes apparent that this work is unsuccessful, the cost should be charged off to expense at once.

Because of the uncertainty that benefits will be obtained and the uncertainty of the duration of any benefits, the accounting treatment of experimental and development expenditures is optional. They may be capitalized during the progress of the work and the accumulated balance amortized over a definite, even though arbitrary, period or over a definite output of product or they may be written off immediately.

When experimental and development expenditures are characteristic of the business, the practical treatment is to charge them off to expense currently. Chemical companies find it necessary continuously to conduct experimental work to develop new products and to improve processes for producing current products. The most practical method of treating such expenditures is to charge them to expense currently, for it is usually difficult to determine in advance whether and to what extent future periods are to be benefited.

In other industries, experimental and development expenditures may be infrequent and when incurred they are often related to some definite project. While the costs of such work may well be charged to expense currently, it usually is not improper to accumulate them as deferred charges until the results of the work are ascertained. If the objectives are attained, the balance of the deferred charge account may be amortized over an arbitrary, but usually relatively short, period. Such deferred charges should be written off as rapidly as possible and once the period has been fixed, charges should be made on a systematic basis. If the work is not successful, the unamortized balance should be charged off at once.

Consistency of treatment of these expenditures is essential to maintain the comparability of the income statement of one period with those of other periods.

Organization and Reorganization Expenses.—Expenditures incident to the original incorporation of a business such as those for government fees, stamp taxes, attorneys' fees and underwriting costs are capital items. However, it is customary to write them off immediately against earned surplus or as rapidly as possible against current earnings after the business begins to earn profits. Such expenditures do not produce future profits or savings comparable to the benefits which may be derived from development expenditures and the authors do not favor the permanent capitalization of organization expenses. Many accountants approve the amortization of these expenses over a period, but abuse of the practice leads the authors to advocate charging them off as they are incurred.

There is some divergence of opinion among accountants whether promotion fees and expenses, as distinguished from corporate organization expenses, should be permanently capitalized, treated as a deferred charge, or written off. The authors believe that it is better practice to write off these charges as they are incurred. Certainly they should not be concealed in overvalued property accounts. This practice has been frequently condemned by the Securities and Exchange Commission, and rightly so.

Expenditures incurred in a reorganization or recapitalization of a corporation should be accounted for in a manner similar to original organization expenses. It may be unnecessary to set them up as deferred charges if there is an accumulated surplus against which they may be charged.

A distinction should be made between expenditures incident to incorporation or to the creation, rehabilitation, or modification of the capital structure of a business and other expenditures, equally necessary, perhaps, to its initial development, but from which future operations will benefit. For example, the cost of installing an accounting system is frequently included as a part of organization expense, but such expenditures are more correctly treated as deferred charges to be written off against future operations.

INTERNAL CONTROL

Capitalization, amortization, and write-offs of prepaid expenses and deferred charges should be properly authorized. Authorization for distribution of routine prepaid expense and deferred charges may

be by an officer or employee to whom such authority has been delegated. Authorization for the accounting treatment of debt discount, expense, and premium; experimental and development expense; organization and reorganization expense; and such unusual items should come from the board of directors or other executive body.

The use of registers for distribution of prepaid expenses and deferred charges affords some measure of internal control in that it assembles these amounts in one place and gives a clear picture of what has been charged to expense and what is to be so charged.

AUDITING PROCEDURES

Objectives.—The auditor should ascertain that the amounts of prepaid expenses and deferred charges are determined in accordance with generally accepted accounting principles and that they reasonably represent the cost of benefits which will be reflected in future operations.

Under a well-organized accounting system, the auditor will find subsidiary records showing details of the company's computations of prepaid insurance, taxes, and interest and of the balances of deferred charges. The client's computations should be reviewed with reference to insurance policies, tax bills, leases, and other documentary evidence. If adequate subsidiary records are not maintained, the auditor should substantiate any balances in prepaid and deferred accounts by reference to whatever documentary evidence is available.

Prepaid Insurance.—If an insurance register is not maintained, a schedule of prepaid insurance should be prepared by the client's staff, if possible, or by the auditors, if the client's staff is unable to prepare it. The register or this schedule should show for each item the policy number, insuring company, coverage (general or specific and amount), date of policy, expiration date, effective period, prepaid amount at the beginning of the period, premium paid during the period under review, and prepaid amount at the end of the period. The information given in the register or schedule should be checked or test-checked. Insurance policies and vouchers supporting premiums should be examined, noting, in addition to the items in the schedule mentioned above, the beneficiary, coinsurance clauses, special assessment clauses, and any evidence of liens on the property insured. If the insurance policies are not available for inspection, the auditor should ascertain the reason. Since lenders often hold insurance policies as collateral for loans, the absence of policies may indicate the existence of liens on the property. The auditor should

request the client to obtain the policies for his examination. If inquiry reveals that insurance is in effect for which the client has not been billed, the auditor should point out the necessity of recording appropriate amounts as asset, liability, and expense.

Computations of amounts prepaid at the end of the period should be checked approximately. The basis of the computation is customarily pro rata, not at the short cancellation rate. Prepaid amounts of liability and compensation insurance, when the premium is based on pay rolls, may be checked by review of pay rolls since the effective date of the policies to determine that proper charges have been made to expense for this insurance coverage. Often earned premiums may exceed the advance payment and there will be a liability at the end of the period rather than a prepayment.

The total in the prepaid insurance register or schedule should be checked and compared with the general ledger controlling account.

The auditor is not an expert in determining insurable values, but he may sometimes render helpful service to his client by comparing the amount of coverage with the insurable value (if available) and book value of the property insured. If overinsured, a useless expense is incurred; if underinsured, an unjustifiable risk is assumed.

Fidelity insurance coverage should be reviewed to determine whether requirements of the by-laws, if any, have been met and whether the amount seems adequate. The auditor may question the apparent adequacy of the type or amount of fidelity bond carried, or, if conditions have changed since the client's last review of the sufficiency of this coverage, he may suggest a reappraisal of the coverage. He may also raise a question with the client as to the coverage of any individual when the amount appears to be abnormally low.

Prepaid Taxes.—The auditor should determine that the amount set up as prepaid taxes is actually an expense applicable to future periods. He cannot rely on general principles entirely, because taxes imposed under the authority of the several states and their subdivisions involve statutes at wide variance with each other in their language. He must base his judgment on his examination of tax bills and the laws of the jurisdiction to which the client is subject.

Inventory of Supplies.—If the inventory of supplies other than those used in manufacturing is substantial in amount, auditing procedures described for inventories in Chapter 11 are applicable.

If this inventory is not substantial in amount, various auditing procedures may be applied. Supply accounts should be scrutinized and balances at the close of the period should be compared with those

at the beginning. Significant differences should be investigated. Test counts of physical inventories may be made and compared with perpetual and book records. Methods of handling supplies may be reviewed and suggestions made to correct weaknesses. Unnecessary waste can often be avoided by reasonable attention to receipts and issues. Obsolete items should not be included in inventory amounts.

Prepaid Commissions.—The auditor should investigate the propriety of amounts of prepaid commissions. It may be advisable to examine contracts with salesmen or obtain from the management an authoritative statement of the terms of employment. Commission records or other evidence of commissions earned may be scrutinized; entries in the salesmen's accounts may be traced from commission records and from cash records. If there are many salesmen, the examination may be restricted to the accounts of only a few of them or to the entries of only a portion of the period. Transactions of the last month of the period and the first month following the end of the period may be reviewed to determine that commissions have been properly applied to the period to which they belong. Confirmation of prepaid commission accounts may be requested from the salesmen, but this is not usually done. If there is a subsidiary ledger for these commissions, the balance of the controlling account should be compared with the trial balance of the subsidiary ledger and any differences investigated.

Advances to Employees for Expenses.—Amounts advanced to salesmen and other employees for expenses should be substantiated by an examination of cash disbursements, expense reports and cash receipts. If employees are advanced amounts as working funds on an imprest basis, the auditor should examine reimbursements in the month following the end of the period to determine whether there were expenditures of material amount prior to the end of the period that had not been reimbursed. Advances should be confirmed by correspondence with the employees. The controlling account should be compared with the subsidiary ledger and any difference adjusted.

Unamortized Debt Discount and Expense.—The auditor should determine that accounting for unamortized discount and redemption premium on bonds refunded is in accordance with generally accepted accounting principles previously set forth. He should be familiar with the full text of Accounting Research Bulletins, Nos. 2, 18, and 32, before attempting to apply these principles to any particular

refunding. He should check the computation of amounts charged to expense or capitalized by charges to construction during the period. He should determine that when bonds are partly retired the related discount and expense is written off, leaving as the unamortized balance in the account the amount relating to the unretired bonds. He should also ascertain that capitalizations, amortizations, and write-offs of debt discount and expense have been properly authorized, usually by the Board of Directors or other executive body.

Experimental and Development Expenses.—The auditor should determine that amounts of experimental and development expenses set up to be distributed over subsequent periods properly reflect these expenses and that the basis of amortization is reasonable. He should check the computation of amounts periodically amortized and ascertain that the policy of amortization has been properly authorized and has been consistently followed from period to period.

Organization and Reorganization Expense.—The auditor should examine the certificate of incorporation, minutes of stockholders' and directors' meetings, agreements with underwriters and stock salesmen, and correspondence with attorneys to determine that amounts capitalized as organization and reorganization expense, either permanently or for distribution to subsequent periods, properly reflect such expense. He should ascertain that the accounting treatment of these expenses is defensible and, if amounts are being amortized, that the basis is reasonable, that computations of amortized amounts are correct, and that the amortization policy has been consistently followed.

Suspense Debits.—Customarily included under deferred charges are suspense debits, items representing expenditures, the final distribution of which cannot be determined. They may be charged ultimately to plant accounts, to other assets, or to expense. This classification of accounts is authorized by certain regulatory bodies and is found more frequently in public utility companies than in industrial companies. In general, this classification should be discouraged and the client urged to determine the distribution of these amounts prior to the end of the period.

In practice, final distribution cannot always be determined and when the auditor finds suspense debits in the accounts he should ascertain that the amounts appear to be correct and that they are properly so classified, because distribution is not determinable at the balance sheet date.

Other Prepaid Expense and Deferred Charges.—Other items may fall under the classification of prepaid expense and deferred charges. For all such items the auditor should pass on the propriety of the classification and of the period over which the expense is to be distributed. He should exercise his judgment in determining reasonable accounting. Computations of amounts of amortization should also be checked. Prepaid rents may be substantiated by examination of leases and vouchers.

Coordination of Examination with That of Related Accounts.—In his examination of prepaid expense and deferred charges, the auditor ordinarily will have accumulated information substantiating in whole or in part the following accounts:

Insurance expense and insurance premiums payable

Property tax expense

Supply expense

Commission expense and commissions payable

Current period expense for amortization of debt discount, expense, and redemption premium, experimental and development expense, and organization and reorganization expense.

Time of Examination.—Most of the auditor's work in substantiating prepaid expense and deferred charges may be done prior to the end of the period. If the client maintains an insurance register, prepaid insurance may be examined at an earlier month end and entries between the date of the examination and the end of the period scrutinized. Physical inventories of supplies may be taken at an interim date and subsequent entries reviewed. Debt discount and expense, experimental and development expense, and organization and reorganization expense are often completed before the end of the period and they may be substantiated as soon as all or most of the expenses have been recorded. Amounts of amortization can be computed only when the accumulation is complete, but this computation can frequently be made before the end of the period.

Other examinations, such as those of prepaid taxes, prepaid commissions, advances to employees, and suspense debits are usually made shortly after the end of the period, although some preliminary analyses may be made at a prior date. As previously indicated, when an examination is made at an interim date, it is advisable to review transactions between that date and the end of the period.

STATEMENT PRESENTATION

Current or Noncurrent.—Accounting Research Bulletin No. 30, issued in August, 1947, sets forth the opinion of the committee regarding the basis for determining the classification of prepaid expense as current or noncurrent. It says:

> For accounting purposes, the term *current assets* is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as . . . . prepaid expenses such as insurance, taxes, unused royalties, current paid advertising service not yet received, and other items which, if not paid in advance, would require the use of current assets during the operating cycle.
>
> The ordinary operations of a business involve a circulation of capital within the current asset group. Cash, when expended for materials, finished parts, operating supplies, labor and other factory services, is accumulated as inventory cost. Inventory costs, upon sale of the products to which such costs attach, are converted into trade receivables and ultimately into cash again. The average time intervening between the acquisition of materials or services entering this process and the final cash realization constitutes an "operating cycle." A one-year time period is to be used as a basis for the segregation of current assets in cases where there are several operating cycles occurring within such time period. However, where the period of the operating cycle is in excess of twelve months, such as in the tobacco, distillery, and lumber businesses, the longer period should be used.

In practice, if a material portion of prepaid expense will be absorbed within the operating cycle, the total may be classified as current. If the noncurrent amount is so large that its inclusion in current assets impairs the significance of working capital, an appropriate amount should be shown as noncurrent.

Credit Balances in Prepaid Commission Accounts.—Credit balances in prepaid commission accounts, if significant in amount, should be shown as current liabilities.

Unamortized Debt Discount and Expense.—Unamortized debt discount and expense is customarily shown as a deferred charge, usually separately stated. Disclosure of the method of amortization is not mandatory except in statements filed with the Securities and Exchange Commission. However, if unamortized discount expense

and redemption premium on bonds which have been refunded are carried forward, the method of amortization should be disclosed and the amount of the annual charge, if significant, should be shown separately from the charges for amortization of bond discount and expense on bonds outstanding.

Organization and Reorganization Expenses.—Organization and reorganization expenses when deferred are usually shown separately on the balance sheet, toward the end of the list of noncurrent assets. Some regulatory bodies prescribe the inclusion of these expenses among fixed assets. If the balances are being amortized, it is desirable, even though not mandatory, so to indicate.

Suspense Debits.—Items included in suspense debits pending final disposition by regulatory bodies, if significant in amount, should be disclosed.

CHAPTER 16

CURRENT LIABILITIES

The principal problem in the examination of liabilities frequently lies in ascertaining their existence rather than in determining their amounts. Most liabilities are fixed and definite in amount; opinion is seldom important, therefore, in determining amounts at which liabilities should be stated. An account receivable considered to be collectible may prove to be uncollectible, but an account payable of a going concern ordinarily must be paid in full.

Three classes of items are generally found on the credit or right-hand side of a balance sheet: liabilities, capital, and items which, in

whole or in part, are liabilities or capital according to the circumstances.

Examples of credits which sometimes have been treated as liabilities but which, under certain conditions, may be more in the nature of capital are:

(a) Debts to stockholders which may be specifically subordinated to claims of all other creditors, or assessments paid by stockholders and carried on the corporation's books as loans payable, which may be held to be capital if the facts disprove the entries on the books.

(b) Certificates which appear on their face to be evidences of indebtedness but which are so restricted in legal remedies that the holders thereof, in event of bankruptcy of the issuing corporation, may rank with stockholders rather than creditors, such as "Twenty-year five per cent debentures, subordinate in every respect, in the event of liquidation, to claims of all other creditors."

(c) Deferred credits which frequently involve substantial obligations to render services and thus include not only unearned income but also a liability for the cost of rendering service. The amount received by a publisher for a magazine subscription will normally represent both liability to incur certain costs and profit which will find its way into income.

(d) Reserves for various contingencies, such as self-insurance, loss on foreign exchange, and taxes, which may not be needed, in part or in their entirety, for the purposes for which they were provided. As set forth in Chapter 18, in which reserves are discussed, if the contingency for which the reserve is provided eventuates, an amount equal to the reserve, in whole or in part, becomes an account payable. If the contingency does not eventuate, the amount of the reserve should be transferred to surplus either directly or through the income account, depending upon the circumstances.

Amounts properly identified as liabilities usually fall into one of three groups: current liabilities, long-term liabilities, or contingent liabilities. This chapter will be limited to a discussion of current liabilities; long-term and contingent liabilities are considered in subsequent chapters.

ACCOUNTING PRINCIPLES

General Principles.—Current liabilities are considered in Accounting Research Bulletin No. 30, issued in August, 1947. The term "current liabilities" is used principally to identify and designate debts or obligations, the payment or liquidation of which is reasonably expected to require, ordinarily within one year, the use of current assets or the creation of other current liabilities.

Current liabilities on the balance sheet include the following:

1. Obligations for items which have entered into the company's operating cycle, incurred in the acquisition of materials and supplies to be used in production of goods or in providing services to be offered for sale, such as notes, acceptances, and accounts payable;
2. Obligations resulting from collections received in advance of delivery of goods or performance of services, such as advance collections on ticket sales, when the performance of services called for will normally be made in the ordinary course of business;
3. Obligations arising from the receipt of certain deposits, such as those to guarantee good faith, to guarantee payment of bills, or to insure return of containers;
4. Obligations which arise from operations directly related to the company's operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and taxes other than income taxes;
5. Obligations, the regular and ordinary liquidation of which is expected to occur within a relatively short period of time, such as short-term debts, serial or other maturities of long-term debt, and agency obligations arising from the collection or acceptance of cash or other assets for the account of a third party;
6. Obligations for income taxes, even though the entire amount may not be payable within twelve months;
7. Operating accruals for known obligations which are expected to require expenditures within a year, even though:
   (a) The amount must be approximated (accruing bonus payments),

(b) Specific persons to whom payments will be made cannot be designated (guaranteed service costs or repairs of products already sold),

(c) Accruals must be measured by current transactions, such as:

(i) Obligations on equipment trust certificates, measured by rents or revenues received,

(ii) Obligations on property, measured by depletion of natural resources.

Certain exceptions to the classification of maturing long-term debt as a current liability are discussed in Chapter 17. Occasionally supplemental agreements are entered into with reference to obligations which on their face are long-term debts. By reason of such agreements, all or part of the debts in reality may be current obligations and should be included in whole or in part in current liabilities. If the auditor observes that long-term obligations are being reduced at frequent intervals, he should ascertain whether the reductions are voluntary or are required by agreements not embodied in the original or expressed terms of the obligations.

If an obligation involves a long-term deferment of delivery of goods or services, such as a long-term warranty or an advance receipt by lessor of rental for a final period of lease as a condition to execution of lease, it need not be classified as a current liability. When definite assurance can be obtained that a loan on a life insurance policy will be liquidated only from the proceeds of the policy upon maturity or cancellation, the loan should not be classified as a current liability if the cash surrender value of the policy is not classified as a current asset.

Some companies follow the practice of recording only invoices for materials which have been received and checked. When this is the policy, it is likely that at the end of any accounting period an unrecorded liability may exist for material in transit and for material which has been received but not checked. Some companies have been known to exclude both from inventory and from accounts payable large quantities of material received near the close of the period, especially if invoices covering the shipments were delayed. While no misstatement of income may result from this practice, it results in an understatement of both inventory and accounts payable.

In Chapter 11 considerations of title in relation to recording of invoices for inventory items are discussed and the conclusions reached are generally applicable to the recording of other invoices.

Generally, liability for payment is recorded upon receipt of goods or services, or upon receipt of an invoice, whichever is first.

However, if material merely has been ordered and at the balance sheet date the goods have not been received nor has title passed to the purchaser, the liability is in the nature of a commitment and need not be recorded as an account payable.

Accounts Payable.—The term "accounts payable" includes those debts and obligations which are not evidenced by notes, bonds, acceptances, or other specific promises to pay. It includes all debts due on open account for operating, agency, and other purposes except accrued expenses, operating reserves, advance collections, and similar items which should be stated separately. Accounts payable usually arise from completed transactions, principally with trade creditors.

Accrued Vacation Pay.—Usually an agreement for vacation pay specifies the period of vacation and the period upon which it is based; for example, two weeks' paid vacation may be granted to each employee continuously employed for the period May 1, 1948 to April 30, 1949. The estimated cost of paid vacations to be taken after April 30, 1949, should be accrued by charges to expense during the year ended that date. For office employees and others not customarily covered by wage agreements, it is not usual to accrue vacation costs in the absence of a legal obligation, as the work load is absorbed by associates during the vacation season. When, however, the company, through announcement to such employees, commits itself to grant vacations in the succeeding year, an accrual should preferably be provided. As indicated later, legal opinion may be necessary properly to interpret the incidence of liability for vacation pay.

Deferred Credits.—It has been customary to treat deferred credits as current liabilities when the services for which they represent prepayments are to be performed within one year from the date of the balance sheet. Some accountants object to their inclusion in the current liability section of the balance sheet on the ground that they do not always constitute a liability to be liquidated in cash. Others contend that, because they will eventually be transferred to income, they should be shown on the balance sheet in a separate classification just ahead of the capital section. When items such as rent collected in advance and advances received on uncompleted contracts involve a substantial obligation to render services and failure of performance may call for liquidation in cash, or when expendi-

tures will be required within the ensuing period to realize the earnings included in the deferred items, the authors believe such items should be included among the current liabilities.

Transportation, amusement, and other companies ordinarily sell tickets in advance of furnishing services. These collections should be treated as unearned and as current liabilities until the companies have completed their part of the agreements.

Many publishers of magazines and, to a lesser extent, of newspapers, receive payment in advance for issues to be distributed during ensuing subscription periods. At any date, therefore, amounts received for subscriptions include unearned income applicable to future issues. The unexpired portion of subscription amounts should be recorded as a liability. The tendency of publishers to sell subscriptions for more than one year emphasizes the importance of recording the liability for unexpired subscriptions in such a manner as to distinguish clearly between the amount applicable to subscriptions to be fulfilled within one year and the amount applicable to subscriptions which will not be fulfilled until after one year from the date of the balance sheet.

Customers' Advance Payments.—When part of the sales price has been collected in advance, the transaction is variously recorded as: (a) a sale in the full amount of the sales price, the difference between that amount and the advance being treated as an account receivable; (b) a sale in the amount of the advance; or (c) a liability to customers for advances. The proper method is to treat the amounts as liabilities to customers until the sales have been consummated by delivery of the goods.

Customers' advance payments received by department stores usually relate to so-called "lay-by" or "will-call" sales under which the selected merchandise is set aside for delivery upon completion of payments under terms of the sales. These arrangements frequently call for regular payments over a period of time, and they are akin to installment selling except that the goods are not delivered until paid for in full. Advance payments are common also where special orders are received for goods not regularly in stock, and the balances due on these orders become collectible upon delivery of the goods. Advances are usually involved only when customers have not established credit standing.

When part of the sales price has been collected in advance, some large department stores use method (a) described in the second preceding paragraph when the balances due are customarily collected

in due course and the merchandise has been segregated for delivery or provision has been made for the cost of goods not on hand at the time the order is received. Other stores use method (b) but, if this is done, an account should be provided to record the approximate cost as determined by the percentage of the entire cost to the amount of the entire sale, so that only the appropriate margin of gross profit will be reflected on those sales.

Security Deposits.—A utility company may require deposits to secure payments of bills and may pay interest thereon. Under the regulations of some state utility commissions, companies are required to pay interest periodically, either in cash or by deductions from bills. Otherwise, interest is not usually paid until the deposit is returned or credited to the depositor's account and this may be many years later. Many receipts are lost or destroyed and demand for return of the deposit may never be made. Nevertheless, these deposits should be reflected as liabilities and interest should be accrued until sufficient time has elapsed after discontinuation of service to indicate that return of the deposit is unlikely. Under the laws in some states, unclaimed deposits are turned over to the state after the lapse of a statutory period of time.

Returnable Containers.—Deposits are required in certain industries to insure the return of containers in which the product is shipped, the cost or other valuation of such containers being included either in the inventory or in the fixed assets of the company. These deposits usually are recorded through charges to accounts receivable and offsetting credits to a container liability account, although they may arise through cash receipts. If charges to accounts receivable are customarily settled by credits for the return of containers, the container liability account may be offset against accounts receivable and therefore it is desirable to segregate the liability for containers arising from cash receipts from the liability recorded by charges to accounts receivable. If customers habitually pay a portion of or all container charges, the container liability account should not be offset against accounts receivable and this segregation is not necessary.

Customers often for one reason or another do not send back returnable containers and the deposit account should be adjusted periodically so that the balance reflects estimated refunds to be made on containers returned or to be returned. The cost of containers not to be returned should be eliminated from the asset account and the difference between the deposit and cost charged or credited to the income account.

Basis of Recording.—For the most part, current liabilities are fixed and definite in amount and are ordinarily based upon completed transactions, incompleted transactions with known liability, or transactions to be completed upon the basis of known conditions.

Usually accounts payable are recorded at amounts due after trade discounts but before cash discounts have been deducted. Trade discounts ordinarily should not appear on the books of account as they are direct deductions from list prices.

Practice with respect to cash discounts is not uniform. Some concerns which make it a practice to take advantage of all cash discounts deduct the discount from the amount of the invoice and enter the net figure in accounts payable. Others reflect the amounts of the invoices in accounts payable before application of cash discounts, and show no record of discounts until they are realized by payment of the invoices. Either policy is acceptable practice if it is followed consistently.

Accrued liabilities are the least susceptible to precise determination because they are often based upon estimates and certain assumptions. Sinking fund requirements are sometimes based on variable factors and may require estimates.

INTERNAL CONTROL

Notes Payable.—The system of internal control should provide for the authorization, preparation, and subsequent payment, renewal, and recording of notes payable.

All borrowings on notes to be executed in the corporate name of the company, and all renewals thereof, should be authorized by the board of directors. The minutes of the board should set forth the names of the banks or other persons from whom funds may be borrowed, the officers empowered to negotiate the loans, the discretion permitted to such officers as to amounts, interest rates and terms, and collateral, if any, which may be pledged as security for the loans.

The books of account should clearly set forth details with respect to each note issued. If borrowings are frequent, a note register or other subsidiary notes payable record should be maintained and the aggregate amount of notes outstanding, as shown by this record, should be reconciled periodically with the general ledger control account. This detailed record should provide the following information for each note:

Principal amount
Name of payee
Date of issue
Interest rate
Due dates for principal and interest
Payments made on account of principal and interest
Collateral pledged

When a note has been paid it should be effectively canceled and retained in the files of the company.

The system of internal control with respect to acceptances payable should be similar to that for notes payable.

Accounts Payable.—An adequate system of internal control for accounts payable should provide effective procedures for checking invoices before entry and payment, as discussed in Chapter 20; balancing the aggregate of unpaid vouchers as indicated by the voucher register or other record with the general ledger control account at regular intervals; comparing vendors' statements with recorded liabilities; payment of invoices within the discount dates; executive approval of adjustments of recorded accounts payable; and for approval and periodic follow-up by the credit department of debit balances.

Successful embezzlements involving large sums have been accomplished by means of false but authentic-looking invoices from "dummy" companies organized by dishonest employees. An adequate system of internal control should include some procedure under which the bona fides of those who appear on the books as creditors is investigated by an internal auditor or some other employee who is equally independent of the purchasing, disbursing, and accounting functions.

Accrued Liabilities.—Internal control over accrued liabilities such as wages, commissions, rentals, royalties, and taxes is exercised mainly through controls of related expenses. Usually a review of the accrual accounts should be made from time to time by someone other than the originator of the monthly entries.

AUDITING PROCEDURES

Objectives.—The auditor's examination of current liabilities should satisfy him that all material liabilities subject to current payment, liquidation, or settlement are clearly indicated in rea-

sonably accurate amounts in the balance sheet under the heading of current liabilities. He should always be alert to detect possible undisclosed liabilities, particularly when the current position is unfavorable, when the business is unprofitable, or when the engagement is undertaken for purposes which clearly require more detailed investigation than is ordinarily necessary as, for example, in an examination undertaken for creditors or receivers.

Notes Payable.—A list of notes payable outstanding should be prepared, preferably by the client's employees. The list should show amounts of the notes, dates drawn, due dates, interest rates, payees, endorsers, details of collateral hypothecated, if any, and the amount of the interest accrued or prepaid at the balance sheet date. The auditor should compare data on this list with the notes payable record and reconcile the total with the general ledger control account. If loans are customarily authorized by the board of directors the list should be compared with the minutes of directors' meetings, and amounts of loans outstanding during any part of the audit period should be tested by comparison with the authorizations or approvals appearing in the minutes.

Notes paid during the period under audit, if properly canceled by the payee or a bank, constitute vouchers. If they are not so canceled, they should be marked in some way to prevent their subsequent misuse. If notes are issued from a book with stubs, or if specially numbered forms are used, tests should be made to ascertain whether all stubs or numbers are accounted for. Careful consideration of notes issued during the period and an examination of notes paid and canceled between the date of the balance sheet and the date of examination will assist the auditor in concluding whether all notes outstanding at the balance sheet date are reflected therein.

It is customary for the auditor to obtain from holders of notes payable written confirmation of the amount payable and of any assets pledged as collateral. Notes held by banks can usually be confirmed simultaneously with the bank balances. Each bank with which the concern under audit is or may be doing business should be asked for a statement of direct and indirect obligations of the client. The form of request for confirmation illustrated in Chapter 8 usually will be found suitable.

In examinations of financial statements of stock brokers, confirmations of loans payable are usually requested separately from those of bank balances. The following form has proved satisfactory for separate confirmation of collateral loans:

(Date)

(Name of Creditor)
(Address)

Dear Sir:

Please confirm directly to our auditors, (name and address of auditors), the correctness of the following statement of your loans to us and the collateral held by you as at the close of business (date).

In replying to our auditors will you please inform them whether we were otherwise liable to you as at that date, either directly or contingently.

An addressed envelope is enclosed for your convenience.

Very truly yours,
(Signature of Client)

Date of Loan................	Due Date..............	Amount...........
	Collateral	

The above statement is correct.

(Signature of Creditor)

When notes payable to bearer have been sold through note brokers, the request for confirmation of the notes sold should be addressed to the brokers through whom the notes were sold. One form for this purpose follows:

(Date)

(Name of Note Brokers)
(Address)

Dear Sirs:

Our auditors (name and address of auditors) are now making their regular examination of our accounts. They desire that you confirm to them the amount of notes sold through you and outstanding as at the close of business (date).

Please send the desired information directly to our auditors and, at the same time, inform them whether as at that date we were otherwise either directly or contingently liable to you.

An addressed envelope is enclosed for your convenience.

Very truly yours,
(Signature of Client)

Unrecorded Notes Payable.—Deliberate omission of notes payable from the books or financial statements is sometimes difficult

to detect, because the owners of a business or those authorized to negotiate loans for them may issue notes and possibly dispose of the proceeds without making any entry in the accounts. If the lender is an individual to whom inquiries would not normally be addressed, the existence of these obligations may be concealed for an extended period. If these notes then pass into the hands of innocent holders, who, under the law of negotiable instruments, are holders in due course, they may be collected if the debtor is solvent. The alert auditor who notes any unusual item of cash receipts, interest, discount, bonuses paid, or unusual entries in personal accounts of partners or officers, may find a clue to unentered notes payable or misapplied funds.

Acceptances Payable.—Commercial letters of credit are extensively used in financing imports. A letter of credit is a guarantee by the bank which issues the credit that drafts drawn by a seller in compliance with the terms stipulated in the letter of credit will be honored when presented for payment. Drafts drawn by the seller against a letter of credit may be sight drafts or time drafts. Sight drafts require payment on presentation. Time drafts are customarily discounted by the seller of the merchandise at his own bank which forwards the drafts for acceptance and payment at maturity to the bank which issued the letter of credit. Sight drafts are paid or time drafts accepted by the bank against shipping documents. If the merchandise is shipped by the seller against a time draft which in due course is accepted by the drawee bank, the merchandise when received is generally released by the accepting bank to the purchaser against trust receipts.

Audit procedures for acceptances payable should be similar to those described for notes payable. In requesting confirmation from banks of acceptances outstanding, the auditor should include an inquiry regarding trust receipts deposited as collateral.

Unrecorded Acceptances.—Consideration should be given to the possible existence of an outstanding liability on acceptances not recorded in the books. It is possible for a concern to purchase goods, arrange to have a bank accept the vendor's draft, receive and put the goods in stock, and yet make no record of the existing liability until the acceptance becomes due.

The usual comparison of order and receiving records with purchase invoices should disclose any discrepancies arising from carelessness. It is not likely that the additional safeguard of a comparison of creditors' statements with corresponding ledger accounts will be

feasible, because an acceptance usually covers specific invoices and it is not probable that after the receipt of an acceptance the creditor will continue to include the invoices covered by it in statements, even though the invoices represented by acceptances are in fact still unpaid. Banks make a charge for services in accepting drafts, and payments of these charges should be test-checked with the acceptances recorded.

Accounts Payable.—The auditor should test the footings of the trial balance of accounts payable and compare the total with the general ledger control account. Details of the schedule of accounts payable should be compared with unpaid amounts reflected by the ledger or the voucher record. It should be ascertained whether the balances represent specific and recent items only; if they do not, the auditor should determine the reason.

When accounts are past due, the auditor should consider the possibility that notes may have been given in settlement without recording the change in status of the accounts. Because of the difference in the legal characteristics of negotiable notes and open accounts, if it is found that unrecorded notes have been given to settle open accounts, the books should be adjusted to reflect the facts.

Statements received by the client from creditors are useful in substantiating the amounts recorded as accounts payable. The auditor may request the client to obtain statements from selected vendors shown by the records to be creditors at the balance sheet date, as well as from concerns with whom the client regularly does business, even though no obligation is reflected in the accounts at that date. Although many business houses do not regularly issue statements, they will usually furnish a memorandum of the amount due at any stated time.

If the accounts payable appear to be irregular in any respect, or if the auditor has reason to believe that the client may be attempting to conceal or otherwise understate accounts payable, he may request statements or written confirmation of balances direct from all creditors and other concerns with whom the client normally does business. Even though none of the accounts appears to be irregular, the auditor may well request direct confirmation of balances from certain creditors at each examination to test the accuracy of the records, and he should consider the desirability of independent inquiry when large purchases are made from otherwise unknown suppliers. Under some circumstances it may be desirable to check names of the vendors appearing on the list of accounts payable with information appearing

in some credit publication. This procedure will tend to substantiate the bona fides of otherwise unknown vendors' names appearing in the accounts.

The auditor should compare on a test basis entries in the receiving records, immediately before the balance sheet date, with the purchase journal or voucher record to ascertain whether the liability for materials received just before the close of the fiscal period is properly recorded.

When the auditor's examination is not completed until some time after the balance sheet date, the voucher record of the subsequent period should be scrutinized and tests made to ascertain whether any invoices entered therein are applicable to the audit period. It should be remembered that the date of an invoice may not represent the date of shipment. It is sometimes the practice to date invoices forward.

The auditor should see that accounts payable include the amount of any known unpaid installments on equipment purchases not represented by, and included in, notes payable.

Totals of expenses and of the various sections of the expense accounts for the last month may be compared with corresponding totals for the previous period. Abnormal differences should be investigated, as they may lead to the discovery of unrecorded liabilities.

If the auditor's examination reveals evidence that goods have been received by his client on consignment, the pertinent records should be examined to ascertain whether any of the consigned goods have been sold without record having been made in the accounts. Amounts currently due consignors for goods sold may be classified as trade creditor accounts in the balance sheet. It is often desirable to obtain directly from the consignor a letter or statement as to the unsold consigned goods and current amount due at the balance sheet date.

The auditor should ascertain that allowances for retroactive discounts based on volume of business, as indicated in agreements with suppliers, have been recorded.

Debit balances in the voucher register or accounts payable ledgers, if significant in amount, should be investigated and given the same consideration as to collectibility as is given to accounts receivable. Investigation of the debit items may indicate that they are applicable to unrecorded invoices, in which event appropriate adjustment should be made for the unrecorded liability. Investigation may also show that such items may be deducted when paying invoices already recorded, in which event they should be treated as deductions from accounts payable.

Deposits.—The auditor should investigate the procedure followed from acceptance of a deposit to its withdrawal. The safeguards surrounding the handling of such funds should be carefully considered, as deposits are frequently obtained from persons who are not familiar with business methods and who might therefore be taken advantage of by dishonest clerks. Deposits of material amounts should be confirmed by correspondence with the depositors.

Unclaimed Dividends.—The auditor should determine whether the liability for dividends declared but unpaid is adequately reflected as a current obligation. Frequently stockholders cannot be reached and dividend checks are therefore withheld or, if mailed, are returned by the post office. The liability for unclaimed dividends may remain undischarged for some time and it is important that the auditor examine evidence to support charges to the unclaimed dividend account, as experience has shown that dormant items of this character are a temptation to dishonest employees.

Many of the larger corporations, particularly those which have numerous stockholders or bondholders, turn over to fiscal agents the details of dividend or bond interest payments. Under most of these arrangements, the corporations discharge their dividend or interest obligations when they deposit with the fiscal agent funds in the amount of the aggregate required payments. When this is done the auditor is not concerned with unpaid dividend checks or uncashed bond coupons which are obligations of the agent. He should, however, investigate whether the fiscal agent periodically remits to the corporation amounts which are no longer required because of the application of the statute of limitations. The auditor should inquire as to the financial responsibility of the fiscal agent unless such business is handled by a known responsible bank.

Amounts Withheld from Employees and Others.—Under various tax law enactments of the federal, state, and local governments, as well as under agreements with labor unions, local hospitals, and charities, it has become the duty of concerns to collect from employees and others taxes, union dues, hospitalization charges, and similar items, to be remitted to the appropriate authorities. Social security taxes payable by employees on salaries and wages and the statutory withholding for income taxes must be deducted from the employees' compensation by the employer; taxes on dividends paid to foreign stockholders must be withheld by the corporation paying the dividends; taxes on rents, royalties, or other forms of income paid to nonresident aliens, foreign partnerships, or foreign corporations

must be withheld by the payers of such income; in certain localities local taxes on wages or on retail sales must be collected by the payer or the vendor; and union dues and hospitalization or group insurance premiums may be withheld from wages paid to employees, for remittance to the proper parties.

The auditor should investigate whether there is any obligation to make such tax and other remittances and, if there is, he should assure himself that the amount of the liability is properly stated upon the books of account. A review of copies of reports or tax returns accompanying payments after the balance sheet date may indicate unrecorded liabilities. It may be necessary to estimate or calculate the amount of withholdings and compare the estimate with the aggregate of any funds collected from others for the various purposes.

Withholding procedures should be reviewed to ascertain that they are adequate and tests should be made to see that they seem to be functioning properly.

Damages and Other Unliquidated Claims.—It is customary to insure against liability for the more usual types of damages claimed by employees or the public, but insurance policies do not assume an unlimited liability and not all concerns carry adequate insurance. Furthermore, unusual claims for damages may arise out of alleged breach of contract, failure to deliver goods, existence of foreign substances in the company's product, and from other causes. The auditor should inquire about possible liabilities of this general character and should request a letter from the client's attorneys stating and commenting on any pending claims or suits.

It is possible that certain claims have arisen which have not been referred to counsel. For example, salesmen may claim commissions in excess of those paid or accrued, or employees who have been dismissed may claim salaries or other compensation for uncompleted terms of service. Such claims are often handled as purely administrative matters and are not referred to counsel unless substantial in amount. If an auditor finds any evidence which leads him to suspect a material liability of this nature, he should insist on being informed of all the facts.

Advances from Officers, Employees, and Others.—Loans from officers, employees, and others are occasionally made, especially in small concerns, with the accounts as the only evidence of the indebtedness. The auditor should confirm such liabilities by correspondence. The circumstances surrounding these obligations should

be investigated. What appear to be advances may be partial payments on subscriptions to capital stock or on the purchase of real estate or other assets of the corporation.

Judgments.—Occasionally a concern disputes a claim, resorts to litigation, and has a judgment entered against it. If the case is appealed, execution on the judgment usually may be stayed if a bond is given pending final decision. These judgments are seldom entered on the books. Most businessmen consider the entry of an invoice to be an admission of liability, and they will not permit a claim which they propose to fight to be entered as a liability.

The existence of judgments may be detected in various ways. An inspection of lawyers' bills may furnish a clue. If a concern is able to pay but does not do so on principle, the auditor may have no difficulty in learning the facts. If a concern obviously is in serious financial difficulties, the auditor may suspect that judgments have been obtained. In any event, he should request a written statement from the company's counsel as to any judgments of which the latter has knowledge and perhaps he may request an independent report based on a search of public records.

Unclaimed Wages.—When pay roll currency or checks have not been claimed by those to whom due, it is good practice to deposit the funds in the bank with a corresponding credit to a liability account. When the probability that such wages will be claimed becomes remote, the liability may be canceled by a transfer to income, unless the law of the state relating to unclaimed property requires the payment of unclaimed amounts to the state.

The auditor should examine recorded transactions in the unclaimed wages account and, in particular, satisfy himself that charges represent authorized payments or transfers.

Royalties.—In determining the amount of royalties payable at any given date, the auditor should examine royalty and licensing contracts. Many such contracts provide that a minimum royalty must be paid whether or not any liability for royalties accrues on a unit basis. Oil and gas producing companies usually enter into leases which require periodic payments even when no oil or gas has been produced. Such payments are usually termed "lease rentals."

Coal leases frequently call for minimum annual payments regardless of the fact that the leasing company may not have extracted any coal. Publishing companies enter into agreements with authors which provide for a sliding scale of royalties dependent upon the number of copies sold.

The auditor should attempt to ascertain from the royalty contract whether the payments are true royalties, or whether, in fact, they represent payments made for the purchase of a patent, or other property covered by the agreement. If the contract is actually a purchase agreement, the asset and liability should be set up at the date of the contract, and depreciation or amortization of the asset should be charged to expense. The so-called royalty payments should not be charged to expense if these payments represent a reduction in the purchase liability.

The auditor of the records of the licensee or lessee should obtain from his client an authentic copy of the agreement and familiarize himself with its details before starting his examination to determine if the transactions recorded in the books of account have been computed in accordance with the terms of the contract. If any of its terms are susceptible of diverse interpretations, he should have the parties at interest furnish him with a legal interpretation of the ambiguous portions of the contract.

Royalties Based Upon Sales.—If royalty payments are based upon sales, computations should be checked against the results obtained by analysis of sales. Tests of the copies of bills on file should be made to ascertain that the aggregate amount is in accord with that recorded in the books of account. The analysis of sales subject to the terms of the royalty agreement should be examined to the extent indicated by the circumstances.

Royalties Based Upon Purchases.—When royalties are based upon purchases, all purchases should be supported by vendors' invoices and these should be analyzed to ascertain the amount of purchases affected by royalty agreements. An inspection of the order and receiving books may be important because it may disclose transactions which are not in agreement with those entered in the general accounting records.

Royalties Based Upon Production.—In some instances royalty agreements are not based upon sales or purchases but on the quantity or value of goods produced. Then the auditor should review the cost and production records to see whether information regarding the articles produced on a royalty basis is readily available. If accounting records are not kept in sufficient detail to give the essential data, it may be necessary to make a detailed analysis of the production records in order to assemble the required information.

Confirmations.—As an additional check, it is desirable to secure from lessors or vendors statements showing the liability under royalty agreements. A request for confirmation may be instrumental in bringing to light serious differences in interpreting various provisions of the contract.

Comparison of Results of Examination With Contract.—After completion of the investigation of the records pertaining to royalty payments and assembling the necessary information disclosing the results of the transactions, the auditor should compare the data so obtained with the various terms of the contract to see that all of its accounting provisions appear to have been carried out. Any differences should be called to the attention of the principals.

Accrued Liabilities.—Accrued expenses, such as rents, taxes, interest, and similar items, should be ascertained as at the balance sheet date and provided for by charges to the appropriate expense accounts. When the accounts are kept on a basis which currently provides for accruals, it is probable that the more important accrued liabilities will have been recorded as a matter of routine. Nevertheless, the auditor should consider the possible existence of accrued expenses for which provision has not been made; he should compare the details of amounts of such accruals at the end of the period with those at the end of the previous period. The likelihood of accrued interest may be suggested by the existence of notes or bonds payable, of contracts and accounts payable past due, or of accounts with finance companies. Evidence of extensive use of equipment and a relatively small investment in equipment may indicate royalty or rental expense, a part of which may be accrued. Nearly all businesses have a liability for accrued wages, some for accrued bonuses to officers and employees, and many for accrued commissions to salesmen. In companies which have been engaged in labor controversies, reference to union agreements or other inquiry may disclose substantial amounts of unpaid retroactive pay. Frequently the initial deposit on compensation insurance is inadequate, and at the date of the balance sheet an additional liability exists. The alert auditor will use his imagination to discover accrued liabilities to which no direct reference is made in the books.

Once the auditor has established the existence of an accrued liability, the substantiation of the amount to be shown on the balance sheet is largely a matter of computation. Accrued wages can be determined by apportioning the pay roll for the wage period which includes the balance sheet date; interest can be computed by reference

to the principal, the rate, and the time elapsed since the creation of the debt or the last previous interest payment; the amount of accrued royalties will be based upon the terms of the applicable agreement; accrued property taxes depend on local factors but usually represent an accumulation of amounts provided monthly on a basis adequate to reflect the entire liability when the taxes become due.

Labor contracts often provide for benefits to employees or their organizations which may give rise to accrued liabilities at balance sheet dates. Within recent years the liability for vacation pay has become increasingly important in amount.

The auditor should review all labor contracts to determine any liabilities which may have accrued under their provisions. In addition to vacation pay, contributions to employees' welfare funds and similar payments may be required of the employer. It is possible that a published statement of company policy, relied upon by employees, may create liabilities for rights which accrue to them even without formal labor contracts.

Opinion of counsel may sometimes be necessary to determine if legal liability exists at the balance sheet date. Contracts and policies of this nature do not always clearly indicate whether the employees' rights accrue ratably over a period or come into existence in their entirety at a subsequent date.

When the auditor checks an accrual computation made by one of the client's employees, he should not insist upon an adjustment of the books or the balance sheet if his independent calculation produces a result only slightly at variance with that obtained by the employee. Substantial differences should of course be investigated and errors corrected.

Salaries and Wages.—The substantiation of accrued salaries and wages offers few difficulties. Most companies can furnish an exact computation of the accrual at the end of an accounting period. This computation can be tested by the auditor through a review of the method used. In the absence of an exact computation, the approximate amount of the accrual may have been estimated by the client by prorating the pay rolls for the overlapping period, based upon the number of hours or days involved at the balance sheet date. A computation of this type can be easily checked by the auditor through a review of the estimate and a verification of the arithmetical correctness of the calculations involved.

Vacation Pay.—Review of labor union contracts may establish that the company has a liability for vacation pay. When vacation

periods are based upon length of service, a detailed computation of the accrued liability should be prepared by the client. The auditor should review the method in use and make sufficient test checks of the computation to satisfy himself that the amount provided is substantially correct. In the absence of a detailed computation, the approximate amount of the accrual may be estimated on an over-all basis.

Interest Payable.—Many of the liabilities which appear on a balance sheet carry interest. It is not uncommon for accounts payable to bear interest and the auditor should explore that possibility. Loan accounts of partners and corporate officers usually bear interest. Judgments, overdue taxes, and other liens often bear interest at high rates and should be investigated. If bond interest is in default and the indenture provides that interest shall accrue thereon, the balance sheet should include provision for this interest.

Income and Other Taxes.—The number and variety of federal, state, and local tax laws make it impracticable in a book of this kind to do more than indicate a few of the more important features to be considered by the auditor. The complexities of tax legislation are such that for many years separate volumes have been devoted to federal income taxes alone. The following paragraphs, therefore, are not intended to do more than mention certain considerations which should ordinarily receive attention by the auditor.

Many states, as well as the federal government, impose taxes which are based upon the net income of a corporation. Therefore, if a company has taxable net income in the current period, liabilities for taxes will exist and provision for them should be included in the balance sheet. Oftentimes provisions are included in round amounts, indicating that they are on an estimated basis. This practice is satisfactory.

It is one of the duties of an auditor to form an opinion whether the provision for taxes, as calculated by the client, is a reasonable estimate of this liability. While the determination of the actual liability is often difficult and complex, the auditor should have sufficient knowledge of the major taxing statutes to compute the approximate liability. While excess profits taxes imposed during the war years have been repealed, the auditor will find that many situations may arise in the immediate future which will require at least a working familiarity with the excess profits tax laws. In many instances, the years for which excess profits tax returns were filed have not been closed by the expiration of the statute of limitations. In others, carry-backs of net operating losses may reopen the excess profits tax years for re-examination.

The auditor should obtain copies of tax returns and review the file of correspondence with the Treasury Department relating to those years for which it is still possible for the government to make assessments of additional taxes or refunds. He should review the returns, as well as the correspondence, with a view to determining whether there appears to be any likelihood of revisions of taxes for those years. The contingency of possible assessments of additional taxes may come to the auditor's attention as a result of his finding from a review of an agent's report that the client's treatment of debatable items has been challenged. Proposed additional taxes are not always paid in the full amount of the proposed assessment, for the Treasury Department frequently cannot sustain its claims. Consequently, an auditor must consider whether the facts require that the amount of the proposed taxes be included as a liability, or that the possible liability therefor be indicated by a footnote to the balance sheet.

The Internal Revenue Code does not tax all corporations alike. Personal holding companies, insurance companies, and regulated investment companies are all treated differently from ordinary trading or manufacturing companies. Foreign corporations and Western Hemisphere trade corporations are taxed differently from ordinary domestic corporations. Certain charitable corporations and others such as farmers' cooperatives are exempt from income taxes. The auditor reviewing the income tax liability of any company falling within the special classifications should determine whether the company seems to have complied with the applicable requirements of the Internal Revenue Code and the regulations.

Determination of federal income tax liability at an interim date sometimes presents difficulties. For example, the Internal Revenue Code provides a graduated rate of tax for corporations earning less than $50,000. Therefore, if, at the interim date, the earnings have not reached that sum it may be necessary to estimate the earnings for the remaining period in order to determine what rate of tax should be used in computing the liability.

When corporations do business in only one state, determination of the existence and the amount of liabilities for taxes payable to that state is obviously a necessity. When corporations do business in more than one state, the auditor should always consider the possible liability for taxes imposed by each state. The fact that the company has sales representatives or maintains inventories in other states may be significant in determining whether or not a corporation may be considered as doing business in those states.

Property taxes are not levied to cover ownership over a period of time. While the collections may be made to provide for expenses of the government for a certain period, the tax is levied on the owners of property at a certain date. The property tax is a liability on and after the assessment date, and should appear as much in any subsequent balance sheet, offset, if conditions warrant, by a ratable amount shown as deferred expense.

The auditor should not be expected to have knowledge of obscure or unusual local taxes in localities in which he does not practice, some of which may be far distant or even in foreign countries. However, to the extent that any tax liability may be material in relation to the other accounts, the auditor should use reasonable means of satisfying himself that adequate provision has been made therefor.

Bonuses to Officers and Employees.—The auditor should ascertain that the liability for authorized bonuses to officers and employees is recognized in amounts computed in accordance with the authorization. Provisions for bonuses payable in a corporation's stock are liabilities but not current liabilities unless it is necessary for the company to acquire the stock in the market.

Amounts due officers and employees under profit-sharing plans become a liability in the period during which the profits are earned. If the exact amount of the liability cannot be definitely fixed until a later date, an estimate may be made and included at the balance sheet date.

Traveling Expenses and Commissions.—It is important to note whether expense accounts of traveling salesmen and others are received and entered in the proper period. The auditor should obtain a list of the employees who have expense accounts and investigate whether expenses incurred during the period under review have been reported and entered in the books.

Ample provision should be made for all commissions eventually payable on sales which have been billed to customers. As commissions are frequently not payable to salesmen until the customers have remitted, accrued commissions are often omitted from the books. However, as they must be paid from the proceeds of sales on which the full profit has already been taken into the accounts, they should be recorded as liabilities at the time the receivable resulting from the sales is recorded.

Probable Expenses Incident to Service Guaranties.—Many articles are sold under guaranties which may cover service periods

of varying lengths or may be based upon usage rather than time. These guaranties may provide for free service, repairs, or replacement, and may involve a considerable outlay of money on the part of the seller to fulfill obligations under the guaranty. Income on sales covered by guaranties should not be considered as fully earned unless adequate provision has been made for future expenses which may be reasonably anticipated as a result of the guaranties. Consequently, the auditor should investigate the service policy and experience in connection with the sale of a client's product to ascertain whether all such probable costs have been included in the income statement of the period in which the income from sale is recorded, even though such expenses may not be incurred until a subsequent period.

If the sales volume is large, even a test examination of the warranty service reserve to determine its adequacy may involve considerable study of statistical data. Facts which ordinarily are pertinent to such a determination include (1) the percentage of total units sold which may require service, (2) the average annual cost of service, and (3) the warranty period. From such data a reasonable estimate of the required service reserve can ordinarily be computed. Applicable expenses subsequently incurred may be charged against the reserve.

Certain products are built according to specification with the understanding that the manufacturer is required to bear the expense of correcting any variation from specifications or latent defects when tested. If experience shows that such adjustments are being made with any degree of regularity, adequate provision for the obligation should be made by a charge against income and a provision retained in the accounts until the products have been finally accepted by the customer.

Profit-Sharing Coupons.—When profit-sharing coupons, trading stamps, or the like are issued by a company to its customers along with the sale of merchandise, a liability to meet the cost of redeeming the obligations is created. To satisfy himself that the provision carried on the books of the concern under audit is adequate, the auditor should review the client's experience in the redemption of these coupons or trading stamps to estimate the percentage ultimately redeemable and, on this basis, to approximate the amount of the liability on outstanding coupons.

Some accountants refer to these liabilities as contingent, but in the authors' opinion it is better practice to carry such a debt as an

accrued current liability. It usually is true that the amount of the liability is not definitely determined until after the date of the balance sheet. However, since payment in money or service required to be made at a later date arises out of sales made prior to the balance sheet date, the estimated liability therefor should be recognized as definite rather than as contingent.

Provisions of Bond Indentures and Note and Preferred Stock Agreements.—Bond indentures and note and preferred stock agreements should be read. They frequently contain provisions for the maintenance of minimum net current assets, for sinking funds, for the disposition of proceeds of mortgaged property sold, or for dividend restrictions. The auditor should ascertain whether any of these provisions have been violated. Violation may constitute default and automatically transfer long-term liabilities into current liabilities.

Undisclosed Liabilities.—One of the auditor's most difficult tasks is the ascertainment of liabilities to which no direct reference appears in the accounts. Clues to such obligations may be discovered in unexpected places and the auditor should be constantly alert, in his examination of assets, liabilities, and capital items, for indications of the existence of unrecorded liabilities. In the preceding discussion some suggestions are made for the determination of unrecorded accrued expenses. However, all undisclosed liabilities are not accruals.

Responses to requests for confirmation of bank loans may list as collateral securities which do not appear on the records. These may have been borrowed from affiliated companies or from others. The liabilities for borrowed securities should be confirmed with the lenders and should be reflected either in the body of the balance sheet or by footnote. Consideration should be given to the possible amount of liability to the lenders of the securities in the event the securities held as collateral should be sold to satisfy the bank loan.

A tour of the plant may, by chance, disclose the existence of major items of equipment not recorded on the books. In one examination the books showed possession of fourteen expensive machines of a certain type, but on a tour of the plant the auditor happened to notice sixteen such machines. It was found that two had been purchased shortly before the close of the year, but that because some adjustment in the purchase price was anticipated, no entry of any liability had been made.

In another examination the auditor observed that one of the buildings of the plant seemed to have been recently re-covered with stucco.

The records showed no expenditure for the labor or material involved. Upon being questioned the client admitted that the liability for the repair contract had not been recorded.

The assignment of fire insurance policies on merchandise or materials is likely to indicate the hypothecation of inventories, with a corresponding liability, possibly unrecorded.

Distributors of nationally advertised branded merchandise sometimes enter into agreements with agents and franchised dealers to supply advertising and demonstration materials in their respective territories. These contracts should be examined by the auditor with a view to the determination of any undisclosed liability on the part of the distributors.

Manufacturers of machinery and equipment often sell their products at a price which includes cost of installation. The auditor should ascertain that adequate provision has been made for the cost of completing the installation of all equipment sold, the profit on which has been recorded in the period under examination.

The cancellation of purchase commitments frequently involves a penalty. Particularly in a period of declining prices, the auditor should determine whether his client may be liable for penalties by reason of such cancellations. Correspondence with the creditors may be necessary to establish whether there is a liability for the cancellation of purchase commitments.

In the audit of contractors' accounts, interrogation of executives and employees may reveal the fact that important portions of jobs which have been finished must be done over at the contractor's expense. Matters of this kind are not always ascertainable from the accounts but the information must be sought, as it may be essential to the preparation of trustworthy financial statements. If a client carries his own insurance risk, the auditor should give consideration to pending claims.

Certificate That All Liabilities Have Been Disclosed.—Many auditors ask their clients for written assurances that all liabilities have been entered in the books or disclosed to the auditors. This procedure is advisable as it provides written evidence that the auditor made proper inquiry from company officials regarding the existence of liabilities not otherwise determinable from the records.

The following specimen certificate may be modified to meet the requirements of particular engagements. If, in any business, there is a particular type of liability not common to business in general, it is advisable to make specific reference thereto in the certificate. It should be understood that a liability certificate is not a substitute for,

but merely complements, a proper examination by the auditor, and acts as a reminder of some liabilities which the client may have overlooked.

LIABILITY CERTIFICATE

(Name and address of auditors)

Dear Sirs:

In connection with your examination of the balance sheet of .... as of................................ I hereby certify that as of that date to the best of my knowledge and belief:

1. All liabilities have been taken up on the books of account including the liability for all purchases shipped and billed to us up to and including that date.
2. No asset of the company was pledged or is now pledged or hypothecated as security for any liability except as follows:
3. There were no contingent liabilities except as follows:

   The term "contingent liabilities" is understood to include among other things:

   Notes, drafts, and acceptances receivable which have been discounted; pending suits; proceedings, hearings, or negotiations possibly involving retroactive adjustments; unsatisfied judgments or claims; taxes in dispute; endorsements, warranties, sureties, or guarantees; commitments for purchase or sale of securities or to repurchase the company's stock, or any other securities; options given by the company, including options on company's capital stock; profit-sharing arrangements.
4. There were no purchase commitments in excess of normal requirements or at prices in excess of the prevailing market prices, nor agreements to repurchase items previously sold, except as follows:
5. There were no other commitments, contracts, or leases which, in my judgment, might adversely affect the company, except as follows:
6. There were no unused balances of letters of credit outstanding other than the following:
7. Contractual obligations for plant construction and purchase of real property, equipment, and patent or other rights amounted to approximately $.................
8. There were no subordinations of assets or liabilities.
9. There have been no material changes since.................. with respect to any of the above items 3 to 8, inclusive, except as follows:

Very truly yours,

Date signed.........................

The liability certificate should be signed by a chief executive, and in most cases should also be signed by the officer responsible for the accounting. In rare instances, an officer or chief executive may refuse to sign a liability certificate. If the auditor decides to express an opinion in the face of such refusal, he should satisfy himself that the refusal is not based upon fraud or intentional misrepresentation.

Coordination of Examination with That of Related Accounts.—Wherever possible the examination of accounts classed as current liabilities should be coordinated with the examination of other related accounts. Schedules of notes payable, acceptances payable, and other loans outstanding during any part of the year should be prepared in such a manner that the interest on these loans can be shown on the schedule and related to the accrued interest payable account and the interest expense account for the period.

Analyses of accrued accounts should be prepared in such a way that the amounts credited to these accounts can be traced to the related expense accounts. These analyses may be particularly important when the auditor also prepares the income and franchise tax returns of the company. He should always have in mind the information required for such returns and obtain the required information when performing the audit functions. This procedure will greatly facilitate the preparation of returns at a later date without the necessity for other analyses of the accounts.

Time of Examination.—Because of the rapidly changing nature of current liabilities, much of the auditor's work thereon cannot be performed until after the accounts have been closed. Current liabilities are not as susceptible of examination and substantiation at an interim date as, for example, property, plant, and equipment.

However, some work can be performed at an interim date to expedite the completion of the final examination at the balance sheet date. The applicable features of the system of internal control can be reviewed, notes payable and other loan accounts can be analyzed for the first nine or ten months of the period, their authorization verified, and paid notes examined.

Accounts for taxes and other amounts withheld can be analyzed prior to the year end to see that funds are being paid to the proper authorities, and that the accounts are cleared at regular intervals. Accrued accounts can be analyzed at an interim date, and consideration can be given to classification of the balances of all current liability accounts when finally determined.

After the close of the period, all analyses and other schedules should be completed and brought into agreement with the closing balances shown by the accounts.

STATEMENT PRESENTATION

Current liabilities ordinarily appear as the first group of items on the liability side of the balance sheet. In general, subgroupings of current liabilities are listed in the order in which they will become due. An exception to this general rule, however, is the accepted practice of stating notes payable as the first item of current liabilities, even though other current liabilities may be liquidated before the notes are due.

Notes and Acceptances Payable.—For some purposes it is desirable that obligations represented by notes and acceptances payable should be so stated that loans from banks, notes sold through note brokers, demand loans, notes to trade creditors, notes to officers and others are clearly distinguished from each other, because the sources of credit may throw considerable light on the financial policies of the business.

It is important that liabilities against which assets have been pledged be shown separately and that the amount of any assets pledged be stated and related to the applicable liability. When pledged merchandise has been released under a trust receipt, it is not always feasible to identify this merchandise after it has been started through the processing procedures. Part of the merchandise may be in raw materials, part in process, and part in finished goods. This problem may be met by including a note to the balance sheet, keyed to the inventory and acceptance payable captions, indicating the amount of merchandise that has been released under trust receipts.

Indebtedness to finance companies should be separately identified, with an indication of the amount and character of the assets pledged against it.

It is desirable to distinguish between notes payable to trade creditors and acceptances payable. The proper description on the balance sheet of acceptances payable is important; if merchandise is pledged to secure them it should be indicated, as the assets so pledged are not available for other creditors. Following are two captions either of which ordinarily will adequately describe the importer's direct liability under bankers' acceptances:

1. Acceptances under letters of credit against merchandise received under trust receipts, or
2. Bankers' acceptances against merchandise received under trust receipts.

In the authors' opinion, the interest rate on notes and acceptances payable, even though higher than the legal or ruling rate, need not be shown on the balance sheet unless this information is required by the person to whom the balance sheet is to be submitted. It may be of interest to creditors but it is of more interest to competitors and the possibility of unfavorable effect outweighs the desirability of disclosure. Also, there may be mitigating circumstances or compensating factors behind a particular rate which cannot be satisfactorily explained on a balance sheet.

Accounts Payable.—The term "accounts payable" may be used as a general caption under which may be listed separately items such as trade indebtedness, advances from officers, bonus awards to employees, dealers' deposits, pay roll withholdings of federal and state taxes, government bond purchases, and union dues.

When the unqualified term is used, the reader is justified in assuming that the item largely represents amounts due trade creditors as a result of ordinary business transactions. Current debit balances that are not direct offsets to accounts payable, if material, should be segregated and reflected in the balance sheet among the current assets.

Accounts payable other than to trade creditors are usually grouped into a separate total for presentation on the balance sheet. This grouping includes such items as customers' credit balances, advance payments and deposits, advances by officers and employees, dividends and royalties payable, taxes collected on behalf of taxing authorities, and claims or awards. If significant, any such item should be stated separately.

Accounts payable to affiliated companies should be stated separately.

It is generally accepted practice not to offset balances with the same trade debtor and trade creditor if settlements of these balances are expected to be made currently by both parties.

Accrued Liabilities.—Obligations of a continuing character, not due at the balance sheet date, and often likely to be larger in amount at their maturity, should be set out separately from those based on completed transactions. In a detailed statement the various types of

accrued liabilities should be shown separately because they reflect different phases of the business, but it is not improper to combine them in one amount if the different kinds of accruals represented are indicated in the title and if they are not abnormal in character or amount.

It is preferable to state separately the liability for income taxes. United States Treasury Savings Notes are accepted in payment of such taxes. In the authors' opinion these notes should be included in the current asset section of the balance sheet rather than shown as a deduction from the accrued tax liability, although the latter treatment seems to be generally accepted if the auditor is assured that it is the intention to apply these notes against the tax liability.

Sinking Fund Requirements Due Within One Year.—Some accountants believe that it is sufficient to indicate the amount of sinking fund installments due within one year for the retirement of bonds in a note to the financial statements or parenthetically in the description of the issue. In the authors' opinion provision for these installments, if material, should be included among current liabilities, unless the company has set aside and segregated from current assets sufficient funds or securities to care for them. Sinking fund installments for the retirement of stock are somewhat similar, although some accountants believe that legal capital should not be reduced on the basis of a prospective payment for the account of stockholders. Any installment in default should be indicated in a note to the balance sheet.

Deferred Credits.—It has been customary to treat deferred credits as current liabilities when the services for which they represent prepayments are to be performed within a year from the date of the balance sheet. Some accountants object to their inclusion in the current liability section of the balance sheet on the ground that they do not always constitute a liability to be liquidated in cash. Others contend that, because they will eventually be transferred to income, they should be shown on the balance sheet in a separate classification just ahead of the capital section. When items such as rent collected in advance and advances received on uncompleted contracts involve a substantial obligation to render services and failure of performance may call for liquidation in cash, or when expenditures will be required within the ensuing period to realize the earnings included in the deferred items, such items should be included among the current liabilities.

Security Deposits.—Deposits often are subject to withdrawal upon demand or upon short notice. Therefore, they should ordinarily be considered current liabilities. In some instances the necessity of refunding more than a small portion of deposits in any year may be so remote that it may not be necessary to classify the entire amount as current. The auditor should be guided by circumstances and classifications prescribed for regulated companies such as public utilities, but current liabilities should include that portion of total deposits likely to be refunded within one year from the balance sheet date.

Deposits for Returnable Containers.—A distinction should be made in the balance sheet by showing as a current liability the amount of deposits for returnable containers received or to be received in cash, and by deducting from accounts receivable, in short, the total deposit liability accounts included in accounts receivable balances for those deposit charges which it is expected will be settled by the return of the containers. If the deposit accounts have not been segregated, it may be necessary to estimate the amount of the charges included in accounts receivable, which are of the nature of memorandum charges to be settled by the return of the containers. The accounts receivable will then appear in the balance sheet at the amount which it is expected will be realized in cash. That portion of the deposit account resulting from cash received is a current liability because the major portion thereof as at the balance sheet date may be refunded in cash after that date. The balance in the deposit account may show little change from month to month, but the containers against which the deposits apply move very rapidly.

When cash deposits are included in cash and the containers for which the deposits are made are included in inventories or fixed assets, there will be a seeming duplication of asset amounts. However, containers represented by deposit liability accounts, shown as current liabilities or deducted from accounts receivable, should not be eliminated from inventory or from fixed assets, as the case may be. To make such an elimination would result in an understatement of assets.

Subordinated Debts.—The prime purpose of subordination of obligations is to protect other creditors. Auditors should analyze the general provisions of subordination agreements for the purpose of determining the effect which should be given them in the balance sheet, but if there is any doubt, and if questions such as publication and recording arise, legal opinion should be obtained. When the fact of subordination is established, full disclosure should be made in the

balance sheet. The inclusion of subordinated items in accounts payable, even though an explanatory note appears, is unsatisfactory; subordinated claims or debts should be stated separately, as current or long-term liabilities, depending upon the circumstances. If the subordination is of a temporary character, the time limitation should be clearly shown lest creditors assume a continuation of the subordination after it has ceased to exist.

Loans to a partnership by general partners are subordinated by the uniform law of partnerships to debts owed to outsiders or to limited partners; loans made by limited partners rank with outside creditors. The fact that loans are owing to limited partners should be shown clearly on the partnership balance sheet but it is not unusual to combine capital of, and loans from, general partners. Unless otherwise provided in the partnership agreement, if the partnership has one or more limited partners, their capital contributions are subordinate to debts owed to outsiders, but rank ahead of the capital contributions and loans, if any, of the general partners.

CHAPTER 17

LONG-TERM LIABILITIES

Introduction.—Long-term loans are frequently negotiated by corporations to finance the acquisition of assets of relatively long life, whereas short-term borrowings are more often incurred to finance short-term working capital needs. The long-term lender often has a lien on specific properties, but he also looks to the earning power of the debtor company for security.

Bonds are a common example of long-term liabilities. Most bonds and some long-term notes and debentures are issued pursuant to terms set forth in a trust indenture. In addition to recitals setting forth the terms of the issue, and a description of the pledged property, the trust indenture includes various covenants for the protection of the lenders.

Long-term liabilities are frequently referred to by accountants and others as long-term debt or funded debt. The latter term appears to have originated in governmental accounting, where it refers to short-term indebtedness which has been converted, or funded, into long-term debt. The word "funded" as used in the term does not imply that assets have been or will be set aside for the liquidation of the liability.

ACCOUNTING PRINCIPLES

Long-Term Liabilities.—Long-term liabilities are obligations having an original maturity date more than one year from date of

creation or assumption. The most common examples are bonds, mortgages, long-term notes or debentures, receivers' certificates, deferred purchase money obligations, advances payable to affiliated companies not subject to current settlement, and certain deposits.

Treasury Bonds.—Bonds purchased or otherwise reacquired by the issuing company are generally called treasury bonds. If they are purchased with the intention of reselling them, it ordinarily is proper to record them at purchase cost. Any profit or loss is taken up in the income account when the bonds are sold. Bonds reacquired by the issuing company for the purpose of retirement may be deducted from outstanding bonds at their face amount.

There is a distinction between treasury stock and treasury bonds which warrants different treatment of the excess of par, stated value or face amount over cost when securities are purchased by the issuing company at less than these amounts and there is no intention to resell them. Bonds constitute a liability, whereas capital stock represents proprietorship or equity. Clearly, if bonds issued for cash are bought in at less than their face amount, there is an increase in the stockholders' equity in the company's assets. It follows that if bonds purchased are not to be resold it is proper to state them at face amount and to credit the profit directly to income. Unamortized bond discount or premium relating to bonds purchased should be charged or credited to the same account as the profit on the transaction.

If the bonds were originally issued or assumed as part of the purchase price of property acquired, the repurchase at a substantial discount, or partial forgiveness of debt by arrangement with the mortgagee, within a relatively short period of time, may indicate that the original issue price was overstated. In these circumstances it may be that the credit arising from the repurchase or from forgiveness of debt should be credited to the property account.

Bonds of Subsidiary Company Purchased by Parent.—When a parent company purchases some of the bonds of a subsidiary company at a discount, they should be carried in the parent company's accounts as an investment at cost. The same is true as to similar transactions between members of an affiliated group. In a consolidated statement of the parent and its subsidiary, the companies are regarded as a single unit and the treatment is the same as when a corporation reacquires its own bonds, assuming, of course, that the parent company does not purchase the bonds for resale. The consolidating entries will bring the bonds back to face amount, credit the purchase discount to income or surplus, and eliminate through the

same account any unabsorbed discount or deferred premium applicable to the bonds purchased.

Premium on Bonds Sold.—When bonds are sold at a premium, the amount received in excess of the face amount represents an interest rebate collected in advance, and should be carried as a deferred credit and distributed over the years to which it applies as a reduction in the nominal bond interest. For instance, a corporation may sell its 5 per cent ten-year bonds at 105, indicating that credit is rated on a basis of about 4½ per cent; that is, if a 4½ per cent bond had been issued, the corporation would have realized about face amount. The excess received at the time of sale should not immediately be applied to income or to surplus, but should be carried as a noncurrent deferred credit and so reflected in the balance sheet until extinguished by amortization. Conversely, when bonds are sold at a discount, the amount of the discount is considered as an additional interest cost and is treated as a deferred charge and amortized over the life of the bonds as discussed in Chapter 15.

Separate premium and discount accounts should be maintained in the general, or subsidiary, ledger for each class or series of bonds issued or assumed by the corporation. Ordinarily, unamortized premium and unamortized discount on bonds are not offset.

Bond Premium Payable at Maturity.—When bonds are to be redeemed at maturity at a premium, good accounting practice requires that a reserve for the amount of the premium be accumulated by annual charges to expense, in the nature of an interest adjustment factor, thus creating a deferred credit sufficient to offset the premium to be paid.

INTERNAL CONTROL

As a procedure of internal control many large corporations and some smaller ones employ a bank or trust company as an independent trustee for long-term liabilities. If the holders of bonds or notes are numerous, a registrar, transfer agent or interest paying agent also may be employed.

When an independent registrar and transfer agent are not employed the corporation's system of internal control should require that all unsigned and unissued bonds and long-term notes be prenumbered by the printer and held in the custody of a responsible officer of the company; that the signing or countersigning of bonds and long-term notes in advance of their issue be prohibited; and

that all surrendered certificates be effectively canceled and filed. The company should also keep a bond ledger in which are recorded the details of bonds issued, canceled, and outstanding. In the absence of an independent interest paying agent control should be exercised over the payment of coupons. All paid coupons should be canceled and preserved after cancellation. Proper control should be maintained, equivalent in scope to that used in safeguarding regular cash funds, over the preparing, signing and mailing of checks for interest on registered bonds and notes, and over the accounting for outstanding interest checks.

The borrowing of funds and the execution of indentures, bonds, notes, mortgages and the like in the name of the corporation should be authorized by the board of directors or the stockholders or both.

AUDITING PROCEDURES

Objectives.—Long-term liabilities are usually substantial in amount and plant or other assets of the company are frequently pledged as security therefor. The auditor should consider whether all long-term obligations are fairly stated, reasonably described and properly classified in the balance sheet. He should ascertain whether stocks, bonds, accounts receivable or other assets have been pledged as collateral for long-term notes and advances payable.

Bonds.—So many different classes of bonds have been evolved that no attempt will be made here to classify them except in a general way. Formerly bonds, if not otherwise designated, were presumed to have real property pledged thereagainst; now many issues of bonds do not have real property pledged but are issued under the terms of an indenture which may include restrictive provisions.

Corporations which issue bonds should have available a signed copy of the indenture stating the terms under which they are issued. The auditor should read the indenture, abstract the important provisions relating to amounts authorized to be issued, interest rate (or rates, as changes are sometimes made), due date or dates (installment payments of principal are frequently provided), property pledged, sinking fund, maintenance fund, working capital and dividend restrictions, basis of issuance of additional securities, and other important provisions.

When bonds are issued under an indenture which provides for a trustee as registrar of the outstanding bonds, the auditor should

obtain confirmation in writing directly from the trustee of the amount of bonds issued and outstanding at the balance sheet date.

All bonds which have been certified by the trustee and delivered to the corporation should be accounted for. If they have been sold for cash or issued for property, the auditor should determine that the proceeds have been properly recorded in the accounts. Unsold bonds should be on hand as authorized but unissued bonds, and the auditor should count them. The auditor should ascertain whether unsold bonds are deposited as collateral for other loans.

When an independent trustee has not been appointed, the auditor should determine that the aggregate of the bonds outstanding as shown by the company's detail bond record is in agreement with the general ledger control account. Canceled bonds should be inspected or otherwise accounted for.

The auditor should ascertain whether the interest accrued on bonds in the hands of the public has been recorded in the accounts and whether the amount due has been paid. Often the payment of coupons is effected through an independent paying agent, with which the debtor corporation deposits the total interest due on each payment date. The terms of the indenture usually determine whether the liability for interest is legally discharged on deposit of the necessary funds with the independent paying agent; regardless of legal responsibility, it is customary to treat the obligation on the books of the debtor corporation as discharged when deposit is made if the paying agent is financially responsible. The auditor may confirm by correspondence with the paying agent the date to which interest has been paid.

Some corporations retain control of the payment of coupons by making their payments through an agent who does not assume liability for ultimate payment and who may or may not be independent of the debtor corporation. The function of such a paying agent is similar to that of a commercial bank which handles a separate pay roll account. Accounts should be kept for the deposits in the hands of the paying agent and for the equivalent liability for matured coupons not presented for payment.

The auditor's investigation should indicate whether there has been a compliance with the various requirements of the bond indenture which are pertinent to his examination. Examples of these requirements are those for sinking fund payments and the related disposition of balances therein; maintenance of certain required ratios, such as the relation of net current assets to the amount of bonds outstanding, or the expenditure of stated percentages of gross

earnings for repairs; restrictions on payment of dividends; insurance requirements; and disposition of proceeds of sale of collateral or properties subject to the lien of the indenture.

If the bonds contain a tax-free covenant under which the issuer agrees to pay a portion of the tax on the bond interest which otherwise would be paid by the owner of the bond, the auditor should see whether his client has made an adequate tax provision.

Mortgages.—Mortgages usually are recorded since otherwise they are invalid as a lien upon the property mortgaged as against innocent third parties. A substantiation of the existence of these obligations can be made by inspecting the public records. The search may also reveal the existence of other unsatisfied obligations, liens, or judgments not recorded on the books. Auditors should not be expected to make such a search as it is in the nature of legal service. The auditor may request a report from a local attorney or title company based on a search of the pertinent records. If the auditor believes that special search by legal counsel is not essential in the circumstances, he should substantiate the amount, the rate, the due date, and the property pledged by examining the indenture and obtaining confirmation by correspondence directly from the mortgagee.

Short-Term Notes.—Short-term notes are generally used by corporations as a means of temporary financing. Obligations regarded as coming within this category usually mature in from one to five years, and except for the shorter maturity differ very little from some types of bonds. They are normally issued under a trust agreement and may or may not be supported by a mortgage or collateral. The audit procedure is similar to that described for other long-term liabilities.

Purchase Money Obligations.—Liabilities of this class represent obligations given as part of the purchase price of property and frequently they are payable in installments over a period of years. If relating to real estate, they may be covered by first, second, or third mortgages, and if relating to personal property, by chattel mortgages. The same procedure as has been set forth in this chapter with respect to mortgages applies to their examination.

Coordination of Examination with That of Related Accounts.—The auditor's examination of long-term liabilities usually is correlated with his examination of certain other accounts. As part of the examination of long-term debt, the auditor should determine that the proper amount of interest has been paid, accrued and charged to

expense for the period under review. When there is an unclaimed interest account he should examine the transactions recorded therein with particular reference to authorizations for the charges to this account. The auditor also should review the accounting principles followed and test the accuracy of resulting balances in the unamortized debt discount and expense and the unamortized premium on bond accounts as at the balance sheet date and of their amortization as shown in the income account during the period covered by the examination.

Time of Examination.—The examination of long-term liabilities and related accounts cannot be completed until after books have been closed for the period under review. However, preliminary analyses and reviews of the entries in these accounts during the period can be made at any convenient time prior to the closing.

STATEMENT PRESENTATION

Classification.—Long-term liabilities, with few exceptions, are classified separately on the balance sheet, based on the conventional division of total liabilities into current and long-term liabilities.

If part of the liability matures or otherwise becomes payable within one year after the balance sheet date, most accountants classify that portion as a current liability, regardless of the nature of the obligation or the purpose to which the funds secured therefrom were devoted. For example, the portion of a serial issue of bonds, or the total of any issue due within one year from the date of the balance sheet and not to be refunded, ordinarily would be shown in the current liability section. If refunding arrangements have been concluded with respect to a maturing issue, or if such arrangements are in process and are reasonably certain of being successfully concluded, the maturing issue may be properly treated as long-term rather than current debt and the circumstances described in a note to the balance sheet. If funds have been provided to retire the maturing obligation and are segregated as noncurrent assets, the maturing liability should remain in the long-term debt category.

It is not considered good practice to deduct long-term liabilities from the assets which are pledged against them. An exception to this rule is that when a company engaged in buying, selling and operating real estate purchases an equity in a property subject to an existing mortgage, but does not assume liability for this mortgage, it may show the investment at its net cost instead of showing the property as an asset and the mortgage as a liability.

Disclosures.—In addition to the title of the long-term debt a description of its principal features including the amount registered, issued, outstanding and in treasury, the rate of interest, the due dates, and sometimes the call price, should be shown on the balance sheet for each issue. When considering liens it should be remembered that, as a rule, unpaid interest ranks as a lien with the unpaid principal.

Often there is real estate or personal property pledged under an issue of bonds. Sometimes a bond is a first lien on certain assets and a second lien on others. As a rule, balance sheets do not purport to describe in detail the real estate pledged under a mortgage, but personal property, such as current assets or securities so pledged, should be designated. The Securities and Exchange Commission, in Rule 3.18(a) of Regulation S-X requires that

> the amounts of assets mortgaged, pledged, or otherwise subject to a lien shall be designated and the obligations secured shall be briefly identified. However, in the case of commercial, industrial, and public utility companies, this rule need not be followed with respect to assets (other than current assets and securities) given as security for funded debt.

If bonds are convertible into capital stock, this should be indicated. Usually the description of the bond indicates its convertibility. The fact that a bond issue is convertible into capital stock may have a decided bearing on the value of the bond of a company whose earnings are increasing.

If long-term liabilities have been subordinated to others by agreement with the lenders, this subordination should be disclosed in the financial statements.

In the event that there has been any default in principal, interest, sinking fund, redemption, or other requirements of the indenture, appropriate disclosure of the facts and amounts should be made in a notation on the balance sheet, and reference thereto may be desirable in the auditor's report.

Treasury Bonds.—Treasury bonds held for resale may be shown separately on the balance sheet as an investment. Reacquired bonds, not held for resale, should preferably be treated as a reduction of the amount of outstanding bonds on the liability side of the balance sheet. It is the usual practice to show on the balance sheet only the net amount of bonds outstanding. If bonds were acquired to be held in a sinking fund, they may be listed among the sinking fund assets at cost with an indication of the principal amount.

CHAPTER 18

CONTINGENT LIABILITIES AND RESERVES

ACCOUNTING PRINCIPLES

Contingent Liabilities.—The term "contingent liability" should be used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arises from past circumstances or actions and may or may not become a legal obligation in the future. The uncertainty as to whether there will be any legal obligation differentiates the contingent liability from an actual liability.

In accounting practice, however, the term has been and continues to be used loosely. There has been a tendency to include in the classification of contingent liabilities actual liabilities of indeterminate amount, such as those arising from litigation of claims for patents, copyright and trade-mark infringement, for breach of contract, claims for additional taxes, or similar liabilities, for which, in the opinion of counsel, there is no adequate legal defense, and with respect to which the amount of actual liability will be fixed, usually by judge or jury,

subsequent to the date of the balance sheet. In the opinion of the authors, if experience or legal opinion provides a basis for a reasonable estimate of the amount of such an actual liability at the balance sheet date, the amount should be stated in the balance sheet. If the circumstances do not permit a reasonable estimate, a disclosure of the facts may be made in a balance sheet footnote. Although the accounting presentation may be similar to that for contingent liabilities, these items should not be so described, because the uncertainty exists only as to the amount and not as to the obligation itself.

The term "contingent liabilities" should not be used to designate items such as accrued expenses and losses, which, while necessarily based to some degree on estimates, nevertheless can be computed with reasonable accuracy and reflected in the accounts. For example, some probable liabilities, such as claims for making good guaranties of merchandise or services, or claims for injuries and damages may be inherent in a business, and the amounts chargeable to current costs and expenses can be reasonably estimated.

Possible losses are sometimes wrongly referred to as contingent liabilities. The possibility, for instance, that property damage may be suffered from tornadoes in certain sections of the country does not create a contingent liability and requires no recognition in financial statements.

Purchase commitments for inventory, fixed assets, or securities are also sometimes considered as giving rise to contingent liabilities, but this is not good usage of the term since the liability is usually certain, not contingent. Some commitments, because of their effect on the financial statements, may be described in the accompanying notes, while others, such as purchase commitments for inventories, may require recognition in the accounts. (See Chapter 11.)

Disclosure of Existence.—The existence of contingent liabilities, if the amounts involved are or may become material, should be recognized and appropriately disclosed in the balance sheet. The fact that a precise amount cannot be established is no justification for failure to indicate the existence of a material contingent liability.

Contingent Liabilities of Indeterminable Amount.—This classification of contingent liabilities includes those items the amounts of which are not determinable. Irrespective of uncertainty as to amounts, they may properly be called contingent liabilities only if there is real uncertainty as to whether the company has any obligation whatever.

Examples of these contingent liabilities are:

1. Guaranties of goods or services.
2. Matters in litigation, such as alleged patent, copyright, and trade-mark infringements, or breach of contract.
3. Possible claims by employees for back compensation under laws, the interpretation of which is uncertain.
4. Possible additional taxes for prior periods.
5. Claims which are founded on contracts but as to which there may or may not be an adequate defense, and with respect to which the amount of liability, if any, will be fixed by judge or jury subsequent to the date of the balance sheet.

This group is not intended to include items as to which past experience or contractual relations, expressed or implied, demand that provision be made in amounts sufficient to charge the fiscal periods affected with all related losses and expenses.

Assessments Under Policies with Mutual Insurance Companies.—Many companies carry fire and casualty insurance with mutual insurance companies under which, in addition to making deposits greater than a normal year's premium, the insured is contingently liable for assessment in the event abnormal losses are experienced by the insurance company. In view of the infrequency with which such assessments have been made in the past, and because any material increase in losses is usually reflected in higher premiums, or lower dividends, in subsequent years, it is not the usual practice to recognize such a contingency on the balance sheet.

Contingent Liabilities of Determinable Amount.—This classification includes items the amounts of which are usually determinable from the records of the company and which may become actual liabilities when and if a primary obligor defaults in payment. Included in this group are those arising from the following transactions:

1. Sale, pledge, or assignment of accounts receivable or installment obligations when the transfer attaches a liability to the seller, pledgor, or assignor, in the event of noncollection.
2. Discount, sale, or transfer of notes receivable, trade acceptances, bank acceptances arising under commercial letters of credit, or domestic and foreign drafts.

3. Endorsement of notes.
4. Accommodation endorsement of commercial paper.
5. Guaranty of payment of interest or principal on the bonds of another person.
6. Sale of real estate subject to a mortgage when the vendor's liability continues under a bond.

All the above contingent liabilities may give rise to contingent assets, i.e., if default necessitates payment by endorsers or guarantors, a right of action against the primary obligor ensues. The fact that contingent assets may arise on default does not relieve the company of the necessity of disclosure of these contingent liabilities, because the necessity of payment of the secondary obligor is prima-facie indication of the doubtful value of the resulting claim against the primary obligor.

Accounts Receivable Sold.—Ordinarily an account receivable may validly be assigned without notifying the debtor of the assignment. In some states, however, an assignment of an account receivable is valid only if some act, such as the filing of public notice, is performed.

When accounts receivable are sold they are usually guaranteed and if the debtor fails to make payment, the vendor is obligated to make good the default by assigning other accounts receivable or transmitting cash. Less frequently accounts receivable are sold outright without any guaranty, and the vendor has, therefore, no continuing or contingent liability.

Accounts receivable may be guaranteed for a consideration, a condition which is found in the relationship between some textile mills and their factors. Here, as in all cases of guaranteed accounts, if it is at all possible to estimate the probable loss, provision should be made for it and it should be carried as an actual liability. When the loss is possible, but not probable, this condition should be indicated in the balance sheet as a contingent liability.

Drafts Sold.—When drafts against foreign shipments are sold to banks at the time of shipment and customers' accounts are closed by credits for cash received from the banks, the books of account do not disclose the amount of contingent liability on drafts sold, but this information is usually available in a subsidiary record.

The terms on which business is conducted with foreign countries are usually long, ranging from 30 days' sight to 90 days' sight and

120 days' dating. Therefore, a large portion of drafts drawn against foreign shipments and sold to banks in the last several months before the close of the period may be outstanding at the date of the balance sheet and the contingent liability for these unpaid drafts should be recognized.

Acceptances.—An acceptance is a draft or bill or exchange across the face of which has been written the word "Accepted" and the signature of the drawee or acceptor. Usually the date of the acceptance is also indicated. When the acceptor is not a bank or banker, there is also inserted the name of the bank or the place at which the acceptance is payable.

A vendor drawing a draft on a customer, which draft is accepted by the bank or banker, may be able immediately to discount it at its own bank or sell it in the open market. The drawer, under certain conditions, can be held liable as an endorser if the acceptance is not paid at maturity, and consequently a contingent liability exists with respect to the drawer until the acceptance is paid by the acceptor or the customer.

Endorsements.—In addition to the contingent liability for notes discounted for the benefit of the endorser, there may be a liability based on endorsements for the benefit of others. These are known as accommodation endorsements.

It is not necessary to discuss this subject exhaustively, but from a practical point of view it may be assumed that every endorsement, whether by an individual, firm, or corporation may become an ultimate actual liability of the endorser. Promissory notes are usually negotiable instruments, and, in order that they may circulate freely, an innocent purchaser for value who acquires such a note without notice of any defect may sue the maker and all endorsers. Knowledge on the part of the purchaser that an endorsement is an accommodation endorsement will not relieve the accommodation endorser of liability.

The assumption that the maker will pay, or that the notes will not find their way into the hands of outsiders, has been dissipated so often that accommodation endorsements must be considered contingent liabilities.

Guaranties.—Almost all the remarks under "Endorsements" apply with equal force to guaranties. However, whereas the liability of an endorser is as set forth in the law of negotiable instruments

the liability of a guarantor or surety depends upon the conditions set forth in the contract of guaranty. Otherwise there is the same likelihood of being required to pay ultimately.

Guaranties of Subsidiaries' Obligations.—Good accounting practice requires full disclosure of contingent liabilities arising from endorsements and guaranties of subsidiaries' obligations and commitments running beyond the date of the balance sheet. Holding companies may guarantee the payment of contracts made by subsidiaries, such as those for merchandise to be delivered at future dates. Full disclosure of these contingent liabilities should be made on the parent company's balance sheet. Such a guaranty would not usually affect the consolidated financial position of the company.

Holding companies sometimes guarantee specified dividends or interest on securities of subsidiaries in the hands of the public. If arrears of dividends so guaranteed have not been paid by the holding company, the liability should be taken up on the balance sheet of the holding company and the fact of guaranty of future dividends should also be disclosed.

Income Taxes on Undistributed Earnings of Subsidiaries.—Income taxes on undistributed earnings of subsidiaries are contingent upon payment of these earnings to the parent company in the form of dividends. They are discussed in Chapter 21.

Reserves.—The term "reserves" has been associated with the holding or retention of assets for a specific purpose, frequently for emergencies; it is used to describe deductions made from the book amount of assets, customarily referred to as valuation reserves; to indicate estimated liabilities or losses; loosely, to indicate various charges in the income statement; and to indicate that an undivided or unidentified portion of the net assets, in stated amount, is being held or retained for a special purpose. Accounting Research Bulletin No. 34, issued in October, 1948, approves as an objective certain recommendations of the Committee on Terminology with respect to the use of the word reserve. The bulletin concludes as follows:

> To summarize, it is recommended that the use of the term *reserve* in accounting be limited . . . . to indicate that an undivided portion of the assets is being held or retained for general or specific purposes and that the use of the term in the balance-sheet, in describing deductions from assets or provisions for particular liabilities and in the income statement be discontinued.

The authors are in agreement with the objectives of the bulletin. They recognize, however, that the term has been long and customarily used in accounting in other than the recommended sense, and that satisfactory substitutes have not as yet been fully developed, particularly for the use of the term in the second sense cited in the bulletin, which states that in this sense the term is used to indicate;

> (a) an estimate of an admitted liability of uncertain amount, as in the case of a reserve for damages, (b) an approximation of the probable amount of a disputed claim, as in the case of a reserve for additional taxes, or (c) an estimate of a liability or loss which is sufficiently likely to occur to require recognition, as in the case of a reserve for self-insurance. These reserves are included in the *liability* section of the balance-sheet, in a section immediately below the ordinary liabilities, or in the *proprietary* section. . . . .

In this book the authors have continued to use the term reserve to identify this class of balance sheet items, and they are discussed under that heading in this chapter. Reserves appropriated from surplus are considered in the chapter on surplus. Valuation allowances have been discussed previously in chapters dealing with the assets whose valuations they adjust; accruals have been considered in the chapter on current liabilities.

Reserves for Admitted or Anticipated Liabilities of Indeterminate Amount.—Accounts which have been established to cover admitted or anticipated liabilities of indeterminate amount are frequently designated as reserves. Items in this category are usually provided for pensions and employee benefits, injuries and damages, fire or other casualty losses, warranties and guaranties, and tax and other specific liabilities of indefinite amount.

Ordinarily these accounts cover the portions of estimated liabilities which are considered noncurrent. Current portions of these liabilities are properly includible in the balance sheet as current liabilities. When the amount of the liability for which the reserve is provided becomes definite and the identity of the obligor is determined, an account payable should be set up. Whether the account payable is set up by transfer from the reserve depends upon the circumstances when it is recognized and upon whether the reserve was created by a charge to income or to surplus.

Reserves of this class may not be required in their entirety for the purpose for which they were provided. If the full amount of the

liability does not eventuate, the balance in the reserve may be restored to income or to surplus, depending on its source.

Reserves for Repairs and Renewals.—In some plants the necessity for repairs and renewals is constant and the aggregate cost of maintenance is about the same from year to year. In other plants major repairs and renewals are required less frequently than annually and maintenance expense fluctuates from year to year. For example, refractory and steel companies may reline their furnaces and gas utilities may paint their storage tanks every four or five years. When maintenance expense fluctuates from year to year it is permissible to establish a reserve account by setting aside a fixed annual amount based on the average over a period of years. To this reserve are charged actual expenditures for repairs and renewals.

The credit balance in the reserve at the end of a period should be carried over as an unused provision, usually as a current liability. At no time should a debit balance in the account be carried over as a deferred asset. If the account shows a debit at the end of the period, the debit should be transferred to the income account and subsequent periodic credits to the reserve should be increased, if necessary.

INTERNAL CONTROL

Contingent Liabilities.—Contingent liabilities of indeterminable amount, because of their nature, are subject to little or no internal control. Contingent liabilities of determinable amount, however, usually may be controlled through the medium of appropriate subsidiary records, such as records of notes or accounts receivable discounted, sold, or guaranteed. When a company follows the practice of discounting notes receivable or selling installment paper, a record of these transactions is of primary importance.

Reserves.—Reserves for estimated liabilities or liabilities contingent as to amount may be based upon experience or studies made by a company. The reasonableness of these reserves should be the subject of periodic review by the management.

AUDITING PROCEDURES

Contingent Liabilities.

Auditor's Responsibility.—Experienced auditors know that contingent liabilities seldom appear as such on books of account and that their existence is generally difficult to establish. As a matter of

fact, it is often almost impossible to ascertain their existence if a deliberate attempt is made to conceal them. Nevertheless, the auditor must make every reasonable effort to uncover and report upon material liabilities of every description, not only those definite and measurable, but also those that are contingent. The auditor should not be expected to determine the probability that a contingent liability may ever become an actual liability; nor should he be required generally to make inquiries regarding possible liabilities which may arise as a result of misleading representations by employees of the client.

The following discussion of general procedures may serve the auditor in his search for possible contingent liabilities.

Inspection of Minute Books.—If the auditor is to submit his opinion of financial statements under examination, he should insist on inspection of the minutes of meetings of stockholders, board of directors, and executive and other committees of the board for the period under examination and up to the date of release of the statements. These minutes may reveal contracts, possible or pending litigation, and other matters indicating contingent liabilities which should be investigated and possibly recognized in the financial statements.

Inspection of Contracts.—The auditor should examine contracts and agreements to which his client is a party to determine whether any contingent liabilities should be recognized in the financial statements. This examination may reveal contracts which produce a material contingent liability which may have an important bearing upon the financial position of the company.

Inquiry and Discussion with Officers and Employees.—The auditor should review with management the possibility of the presence of contingent liabilities. Frequently this review will bring to light the existence of contingent liabilities not otherwise determinable from the accounts. A statement of management as to contingent liabilities is included in the liability certificate discussed in Chapter 16.

Information from Bankers and Attorneys.—Contingent liabilities may be revealed by the banks' replies to the confirmation request suggested in Chapter 8, which includes a request for a statement of the client's liabilities as acceptor, endorser, or guarantor on notes, drafts, and acceptances.

The auditor should also request information from the client's attorneys as to the status of suits and pending litigation; this may

reveal possible claims of substantial amount. The client's records should be scanned for the names of attorneys to whom retainers or fees have been paid and, after discussion with the management, information should be requested from certain or all of these attorneys, depending upon the circumstances. For the protection of the auditor, written replies should be requested.

Accounts Receivable Discounted.—Accounts receivable may have been discounted with discount companies without recording the transaction in the books. The auditor may find a clue to this if the books indicate any transactions with discount companies such as receipts from or payments of interest to them. Indications of dealings with discount companies should be investigated to determine whether any contingent liability exists.

Commitments of Subsidiaries.—The auditor should inquire as to commitments of unconsolidated subsidiaries guaranteed by the parent company. These may not appear in the parent company records but may give rise to a contingent liability that should be recognized in the financial statements.

Bonds of Other Corporations.—A corporation may guarantee the payment of the principal of bonds of another corporation and perhaps the interest and sinking fund payments also. When the guarantor is a parent company and the bonds guaranteed are those of an affiliate or subsidiary, the existence of the guaranty should not be difficult to detect. When there is no apparent relationship between the guarantor and the obligor corporation, and the guarantor has not been called upon to make any payments under the guaranty, the auditor must rely for his information upon a scrutiny of corporate minutes and judicious inquiries from officials of the corporation. Past transactions may also give some indication of the existence of a guaranty, as, for instance, when properties, which are subject to a bond issue, have been transferred to another corporation, and the transferor has guaranteed new substitute bonds issued by the transferee. If a guaranty is disclosed in a note to the financial statements, its nature should be described.

Profit Limitations on Government Contracts.—Profits on certain government contracts are subject to limitations imposed by the Vinson Act as amended, which applies to contracts for the construction of naval vessels and navy and army aircraft, and the Renegotiation Act of 1948 as amended, which applies to contracts for the procurement of ships, aircraft and aircraft parts, and the

construction of facilities or installations outside continental United States. If the client is a party to any of these government contracts, the auditor should investigate the status of the client under these acts and the possible existence of a contingent liability that should be recognized in the financial statements.

Time of Examination.—The examination of contingent liabilities will usually be made in conjunction with that of related determined assets and liabilities. Certain examinations should be continued up to the date of completion of field work and, sometimes, up to the date of release of the report; activities and transactions up to these dates may be of importance in determining that all material contingent liabilities have been recognized.

Reserves.

Auditor's Responsibility.—The auditor's responsibility is to determine that reserves as set forth in the financial statements have been made under accepted accounting principles, consistently followed, and that computations, under the plans or bases followed, have been correctly made.

Reserves for Self-Insurance and Employees' Pensions.—Many companies have established insurance reserves for workmen's compensation and for fire losses. Under these self-insurance plans savings may be effected, representing the profit that would normally accrue to an insurance company and the amount by which a company can reduce its loss and expense ratios below the averages for the industry through safety engineering, education, and fire prevention. Some companies administer their employees' pension plans, saving the profit that would normally accrue to an insurance company.

The auditor should determine that credits to workmen's compensation insurance reserves and employees' pension reserves are based on actual pay rolls, that they are in authorized percentages or amounts, and that their computations are correct. He should determine that credits to reserves for fire losses are in amounts as authorized by proper persons. He may compare them with commercial premiums, but often annual provisions will be less than commercial premiums inasmuch as one of the purposes of self-insurance is to reduce annual premium expense.

Charges to these reserve accounts should be reviewed to determine that they are proper.

The auditor should form an opinion whether balances in these accounts seem adequate for possible claims or losses resulting from

known events up to, or even beyond, the balance sheet date. In this he will be guided by past experience, the experience of other companies in similar activities, inquiry, and possibly by special circumstance.

Other Reserves.—The auditor should examine credits to other reserve accounts to determine that they are made in amounts as authorized and result in apparently adequate provision for the liabilities they are intended to cover. He should ascertain whether charges to these reserves are proper and whether they relieve income of the period of charges that properly belong to it.

Time of Examination.—The auditor will find it desirable at the time of his interim examination to review reserve accounts, both those on the books and those contemplated for the end of the period. Analyses of these accounts up to an interim date may reveal adjustments that should be made prior to closing the books. After the end of the period these analyses should be brought up to the year end and the balances in the accounts reviewed in the light of circumstances both at the year end and just before release of the statements.

STATEMENT PRESENTATION

Contingent Liabilities.—The characteristics of contingent liabilities are such that usually it is not possible to show them in dollars in the conventional manner among the direct liabilities on the balance sheet. For example, while the amount of notes receivable can be stated in dollars, the contingent liability for notes sold has not become actual at the date of the balance sheet; the liability for damages, if any, for breach of contract may not be determinable until awarded by jury and approved by the court. The method most often used to disclose the existence of contingent liabilities in the balance sheet is an explanatory note, which may be placed on the liability side of the balance sheet immediately preceding the capital section or shown as a footnote. The position of the notation on the balance sheet is not important, but a clear statement of significant information is.

A troublesome question that sometimes arises in the consideration of contingent liabilities is whether the materiality of the item justifies disclosure. Contingent liabilities may exist, but may be of immaterial amount. By custom the contingent liability for receivables discounted is usually disclosed even if not material in amount, because some readers of the balance sheet are particularly interested in the manner in which the company obtains its working capital. On

the other hand, the possible amount involved may be large, but the possibility of the event which might cause the contingent liability to become actual may seem to be very remote. Important or significant information should be disclosed. The auditor should not be expected to determine the probability of a contingent liability ever becoming an actual liability.

Disclosure of contingent liabilities should not be considered to require disclosure of information in such a manner as to be detrimental to a company or its stockholders. In opposing the disclosure of details of lawsuits or other claims, the liability for which the company denies, it is sometimes argued that a balance sheet stating the existence and amount of these claims may be offered in evidence by opposing attorneys as an admission of liability. The auditor should, of course, give full consideration to the position of his client, but usually it is possible to explain the contingent liability and at the same time avoid harmful admissions. A statement that the amount of a described contingent liability may be substantial but indeterminate at the balance sheet date and that counsel for the company considers remote the possibility of its becoming a determined liability of significance may suffice.

When contingent liabilities exist at the balance sheet date but are discharged and cease to exist for any reason prior to completion of the audit, the balance sheet should indicate not only the existence and amount of material contingent liabilities but also the entire or partial discharge of them. Failure to make complete disclosure may result in withholding significant information.

Notes and Acceptances Discounted.—After the date of discounting notes or acceptances but before maturity, the amount of the contingent liability of the endorser, which is usually expressed as the principal amount of the notes or acceptances discounted, should be indicated. It is not sufficient to state on the balance sheet that notes or acceptances have been discounted without stating the amount.

Reserves.—Reserves of the type considered in this chapter generally are shown at the end of the liability section of the balance sheet, immediately preceding the capital section. The term "reserve" is not considered an adequate description. Description of a reserve account should include its purpose.

CHAPTER 19

CAPITAL AND DIVIDENDS

CAPITAL

ACCOUNTING PRINCIPLES

Introduction.—Capital is the term used by accountants to describe the owners' equity in a business. It is represented by the excess of total assets over total liabilities, or the property or cash paid in by the owners together with increments or decrements arising during the course of business. The latter definition conforms most closely to the current trend in accounting thought in that it distinguishes the sources from which capital is derived—namely, contributions of its stockholders and the retention of profits in the business less losses deducted from capital. It has been recommended by some accountants that the terms used to describe the different types of capital indicate the sources from which it is derived.

The term "capital" is preferred by accountants to net worth, which was widely used some years ago. Net worth has the disadvantage of suggesting present realizable value. Since the assets shown in a balance sheet prepared in the usual manner are generally a mixture of known values (cash), estimates of current or going concern values (receivables and inventories), and historical costs (fixed assets), the proprietary equity or excess of assets over liabilities, as reflected by the accounts, rarely even approximates present worth of the business.

Capital of a Business Corporation.—A corporation differs from a sole proprietorship and a partnership in that a corporation is an entity separate from its stockholders, whereas a business owned and operated by a sole proprietor or a partnership has no legal standing apart from that of its owners. While it may be convenient for accounting purposes to personify a business and give it an identity independent of its owners, it is primarily in incorporated businesses that this distinction is recognized legally. The capital section of the balance sheet of a business owned by an individual or a partnership reflects the equity of the proprietor or partners in the assets of the business. The capital section of the balance sheet of a corporation reflects the equity of the stockholders of the corporation in its assets and is usually represented on the balance sheet in two sections, capital stock, and surplus. The capital section of many balance sheets is complex and this division may appear to be an oversimplification. However, the division is useful as a starting point for the discussion of the more important considerations of capital.

Capital Stock.—Capital stock represents that part of the amount of capital contributed by the stockholders which the corporation is

expected to maintain intact (other than as reduced by losses or by appropriate legal action) for the protection of the creditors. Such amount may be expressed as capital stock with par value, or as capital stock without par value but with stated or assigned value, and it does not necessarily represent the full amount contributed by the stockholders.

Authorized stock is the maximum that may be sold or issued by a corporation under the terms of its charter and the amount usually may not be increased or decreased without the approval of the stockholders. When the charter is granted to the corporation, all the authorized stock is unissued; it becomes issued stock upon its sale or other disposition at the discretion of the directors.

Issued stock may be reacquired by the corporation either through gift or by purchase. Reacquired shares, unless retired, remain issued stock. Outstanding stock generally is considered to be stock issued and in the hands of stockholders and would not include shares reacquired by the issuing corporation.

Capital stock of a corporation is divided into shares, or certificates of ownership, owners of which enjoy the same rights and privileges as other owners of the same class of stock. Corporations often divide their capital stock into various classes, the most usual of which are common stock and preferred stock. Sometimes other classes such as debenture stock and founders' stock are authorized.

Stockholders have certain rights, privileges, and responsibilities which are governed by the laws of the state under which the corporation is organized and by the charter of the corporation.

Common Stock.—Common stock represents the residual ownership in the business. If there is no preferred or other special class of stock, common stock and capital stock of the corporation are synonymous. Common stockholders are not entitled to any distribution of earnings or assets until the prior claims of preferred stockholders are satisfied.

Common stockholders, by virtue of their ownership in the business, have certain basic rights: usually, to vote and thus to participate in the selection of management; to share in the profits of the business by receiving dividends when and if declared by the directors; and, when the corporation is dissolved, to share in the distribution of assets in accordance with the terms of the charter. Depending on the law of the state of incorporation or on the charter, common stockholders sometimes have a fourth right, called the "preemptive" right, which prevents dilution of the stockholders' equity without their

consent, i.e., they may participate in the purchase of any additional common stock in proportion to their holdings at the time of the new issue.

Preferred Stock.—Classes of stock that have been granted certain preferences or privileges are known as preferred stocks. They may be accorded preference as to dividends, in voting, in liquidation, or in other matters.

Dividend Preference.—Holders of preferred stock generally are entitled to receive a fixed dividend (expressed either in dollars or as a percentage of the par value of the stock) before a distribution is made to common stockholders. The payment of this dividend is not automatic; it is dependent upon declaration by the directors.

The dividend preference may be either cumulative or noncumulative. If the preferred stock is cumulative and if a dividend on the preferred stock is not paid in any year, provision must be made for payment of this dividend (and any other unpaid accumulative preferred dividends) before the directors may properly declare a dividend payable to the common stockholders. These accumulated dividends may never be paid, but, if they are not, no regular dividend distribution may be made to the common shareholders. Therefore, unpaid cumulative dividends on preferred stock constitute a lien on undistributed profits which requires disclosure on the balance sheet. If preferred stock is noncumulative and the directors fail to declare a dividend in any particular year, preferred stockholders lose their right to that dividend and are entitled only to regular dividends in future years. There are also instances of what might be termed "cumulative noncumulative" preferred stock which means that if the preferred dividend is earned in any year and the directors fail to declare the dividend, then no dividend on common stock may be paid until the directors pay the preferred stock dividend previously earned.

Stocks preferred as to dividends may also be classified as participating or nonparticipating. The participation of the preferred stock may be either partial or full. A fully participating preferred stock receives its fixed dividend, the common stock receives a prescribed amount, and any further distribution is to common and preferred stock on an equal basis. A partially or limited participating preferred stock shares in the residual distributable amount after payment of the fixed dividend on preferred stock and after a specified dividend has been paid to common stock, such sharing being limited to an amount not in excess of the specified dividend to common stock. Thereafter dividends are paid to common stock only.

A nonparticipating preferred stock is entitled to its fixed dividend only, not sharing with the common stock in any additional dividends paid. Unless the charter specifies otherwise, preferred stock is nonparticipating.

Assets on Liquidation.—After claims of all creditors have been settled, preferred stockholders generally receive a fixed amount per share before distribution is made to common stockholders. This fixed amount is often slightly larger in voluntary than in involuntary liquidation. Preferred stockholders also are usually entitled to receive accrued or unpaid dividends before assets are distributed to common stockholders.

Preferred stock may also be participating as to assets when the corporation is liquidated. For instance, the preferred initially may receive $100 per share upon dissolution and, after the common receives $100 per share, participate equally with the common in any remaining assets. The amount to which each is entitled is dependent upon the preferred stock agreement.

Voting.—Unless the charter provides otherwise, preferred shares have the same voting rights as common shares. However, the charter usually either deprives the preferred stock of voting power or limits it. Frequently preferred stock is entitled to vote only under certain conditions, such as when dividends have not been declared for a specified period, or when working capital, net assets, or earnings fall below a specified minimum, or in the event of default in other provisions of the corporate charter.

Preferred stock may also be given the right to vote only on certain specified matters, such as the issuance of additional preferred stock or other senior securities, the sale of corporate assets, changes in the by-laws, or other matters as specified in the charter.

Convertibility.—A privilege sometimes granted to preferred shareholders is the right to convert preferred stock, usually into common stock, at the option of the holder. The conversion privilege may make the stock more attractive to prospective purchasers. Conversion generally must be effected within a specified period and the conversion ratio may change with the passing of time.

Redemption.—Most preferred stocks are redeemable at the option of the corporation after a certain date. When the stock is called, the corporation usually pays to the stockholder the par value of the preferred plus a premium and accrued dividends. Sometimes the

premium decreases at fixed intervals after the issue date. If the stock is a no par value stock, the redemption price must be stipulated.

Other Classes of Stock.—There are various other types of stocks which are found rather infrequently in this country. Common stock may be divided into Class A, Class B, and sometimes Class C common. Often one or more of these classes of common stock have all the rights usually associated with preferred stock and are common stock in name only.

Debenture stock may be preferred stock under another name. When debenture bonds have no due date, they also resemble preferred stock.

Founders' stock is usually issued to founders, promoters, or organizers of a corporation and it claims a larger proportion of declared dividends than the remainder of the common stock. For example, 5 per cent of the common stock, the so-called founders' shares, may be entitled to 15 or 20 per cent of the total dividend declared payable to the common. Voting rights are generally the same as those of other shares, but they are often callable.

Par Value Stock.—The par value of capital stock has no inherent relation to its actual worth, nor does it necessarily fix the price at which it will be sold. It is an arbitrary figure which uninformed persons may mistake for real value. If capital stock is sold below par, it is not legally fully paid, and the stockholders may be liable to creditors for the difference between the price paid and the par value.

No Par Stock.—Most states permit the issuance of stock without par value. Each certificate merely states the number of shares which it represents. Some states require that the total number of shares authorized also be shown.

No par stock may be placed on the books of the corporation at a stated or assigned value, which may be equal to, or less than, the subscription price of the stock. No par preferred stock is sometimes stated at the minimum liquidation price. Sometimes a portion of the price paid is credited to paid-in surplus and may be available for dividends. Payment of dividends from this source is discussed later in this chapter.

An accepted method is to credit the capital stock account with the net proceeds of the sale of the no par stock, notwithstanding the fact that it may have been sold at different prices and at different times. There will thus be no charge or credit to any surplus account

and the source of the capital is clearly evident. Another method is to credit capital stock with the net proceeds of the sale of the original issue; subsequent issues are then credited at the same amount per share and the difference charged or credited to paid-in surplus.

Stock Options.—Stock options represent rights given by a corporation, usually to a bondholder, stockholder, officer, or employee, which permit the holder to purchase shares of the corporation's stock at a specified price, during a certain period, and in accordance with conditions set forth in the option. Options, or warrants as they are often called, may be attached to bonds or to preferred stocks to add to the marketability of the issue. The options may be detachable or nondetachable. If detachable, the purchaser of the bond or preferred stock may sell the warrant, exercise it, or permit it to expire. If nondetachable, he must either exercise it or let it lapse.

Stock Options as Compensation.—Stock options may be given to officers or employees of a corporation as compensation for work previously performed or as an inducement or incentive to greater effort. When a corporation issues stock options to officers or employees as compensation, the option price, in order to provide an element of compensation, is generally below the market price of the stock at the date of the option agreement. The option agreement usually provides that during a certain period and upon the performance by the grantee of certain stipulated conditions, the grantee may, at his own election, acquire a specified number of shares of the corporation's stock at the fixed option price. The problems involved in the accounting for such compensation are twofold—first, determining the date as of which the option right should be valued, and second, measuring its value.

There has been some disagreement as to whether the option should be valued on the date of the agreement, on the date the option becomes exercisable, on the date the option becomes the property of the grantee, or on the date on which it is finally exercised. Accounting Research Bulletin No. 37, issued in November, 1948, in discussing options granted to officers or employees of a corporation as compensation, states in part:

> The committee believes the date on which the option right becomes the property of the grantee is the proper date as of which to measure the value of the option. Upon that date the grantee has met all conditions precedent to receiving the option, and the corporation then has an unqualified obligation under the agreement. While this date may not coincide with the date on which the grantee may first exercise his

> option, the committee believes this to be the date as of which the corporation should ordinarily measure compensation resulting from the option agreement.

As to the manner of measurement, the bulletin states:

> When property is given for services, the cost of those services would be determined by their fair value or by the fair value of the property given, whichever is the more clearly evident. While the market price of the shares will usually be an important factor and often the principal factor in determining fair value, market value is not necessarily conclusive evidence. However, there is the presumption that the value of the option should be measured by deducting the price payable by the grantee from the fair value of the shares on the date the option right becomes the property of the grantee. The amount so determined should, in most cases, represent substantially what the corporation could have realized in excess of the option price by sale of the shares on that date. When the agreement contains provisions which defer the date when the option may first be exercised, or which prevent the option from being sold or transferred, the value of the option may be less.

The Treasury Department takes the position that the date exercised is the proper date for determining the value of the option and compensation should be recognized to the extent the fair value of the property exceeds the amount paid therefor.

The amount of the compensation as determined should be charged to income in the period during which the services were rendered, and when the period is not specifically set forth in the agreement, the apportionment should be reasonable in relation to the attendant circumstances. The offset to the income charge should be set up in an account similar to that covering the proceeds from subscriptions to capital stock; such account to be reduced by appropriate credits to the capital accounts as the options are exercised.

Treasury Stock.—Treasury stock is a corporation's own stock which has been issued and subsequently reacquired by purchase or by donation, but not retired. Generally it should not be considered as an asset of the company but as a reduction of capital. An exception to this rule may be when treasury stock has been acquired for the specific purpose of resale to employees or others, when it may be shown on the asset side of the balance sheet at cost. Reacquired stock remains treasury stock until it is either retired, resold, given as bonus, or exchanged for property. Treasury stock cannot be voted. When dividends are paid through a dividend paying agent, they may be paid on treasury stock, but upon receipt these dividends

should be credited to dividend expense and not taken into dividend income.

Retirement of Treasury Stock.—As a general rule, upon the retirement of treasury stock, its par, stated, or average paid-in value is deducted from the related issue of capital stock. Any excess of cost over the amount so deducted is charged to paid-in surplus up to an amount not in excess of the pro rata portion thereof, if any, applicable to the retired shares, and the remainder to earned surplus. It is permissible to charge such remainder to paid-in surplus from a class of stock or shares no longer outstanding. An excess of amount deducted from capital stock over the cost of the shares is credited to paid-in surplus. Reacquired stock of no par or stated value which had been issued at varying prices per share is usually deducted from the related capital stock account at either the original amount received for the shares reacquired or the average issue price of all stock of the class. While it is considered permissible, it is not always feasible to deduct the amount originally received for the specific shares reacquired.

While the foregoing may be stated as the general rule, differences between the laws of various states and differences between lawyers as to the proper interpretation of the laws of a particular state make it advisable to consult counsel for the client in case of retirement of any stock so that book entries and resulting financial statements may be prepared in conformity with counsel's interpretation of applicable state laws.

Disposition of Profit on Resale.—When treasury stock is resold rather than retired, there arises the problem of disposition of the difference between the cost and the selling price of the shares.

The executive committee of the American Institute of Accountants issued on April 8, 1938, a report of the committee on accounting procedure on discussions with the New York Stock Exchange and the Institute's committee on cooperation with stock exchanges. The opinion of the latter committee, as approved by the committee on accounting procedure, reads in part as follows:

> Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation's common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits

> or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock.

The Securities and Exchange Commission issued an opinion of the Chief Accountant (Accounting Series Release No. 6) which reiterated the same reasoning in similar language, and concluded "There would seem to be no logical reason why surplus arising from reacquisition of a company's capital stock and its subsequent resale should not also be treated as capital."

The authors, however, do not know of any example of a corporation reissuing capital stock that is identifiable with stock previously purchased and retired. There are many instances of the purchase by a corporation of its own stock and subsequent resale of the identical shares to other stockholders at a profit. They question the validity of the analogy between (a) and (b) in the opinion quoted above.

Corporations also purchase stock in other corporations and resell it at a profit, and the authors believe that this transaction is analogous to that of purchasing and reselling its own shares. In both transactions the corporation receives the profit and in neither is the capital of the corporation affected.

While the authors continue to believe that recording profits on purchase and resale of its own stock as income or earned surplus is sound accounting practice, they concede that the present-day generally accepted accounting principle is not to record differences between cost and selling price of a corporation's own capital stock in income or earned surplus as a corporate profit or loss. They therefore follow the rule as recommended by the Institute's Committees in their accounting practice. As to a net loss from such sales see "Transactions in Treasury Stock," page 390.

Surplus.—Surplus is generally understood as the equity of stockholders in corporate assets in excess of the par or stated value of the corporation's capital stocks. It is as much a part of capital as is capital stock. It is not represented by or identified with any particular asset or group of assets.

The use of the term "surplus" has recently been the subject of extensive discussion among accountants. It has the unfortunate connotation of excess, overplus, or residue. Moreover, it is in reality capital derived from a specifiable source. The proper distinction to be made is not between capital and surplus, but between origin of capital as (a) capital derived from contribution or proprietary in-

vestment of stockholders and (b) capital derived or accumulated by the retention of earnings. Many accountants, including the authors, believe that financial statements would be improved if the term "surplus" were abandoned.

EARNED SURPLUS.—Earned surplus may be defined as the balance of net income of a corporation from the date of incorporation (or from the date of a quasi-reorganization) after deducting losses, distributions to stockholders, transfers to capital stock accounts when made out of such surplus, and adjustments for extraordinary charges or credits as may be sanctioned by the board of directors and by generally accepted accounting principles. For discussion of extraordinary items in the statement of surplus see Chapter 7.

The term "earned surplus" has been criticized because its meaning is so often misunderstood. Many accountants and others concerned with the preparation of financial statements are turning to expressions such as earnings (or income, or profits) retained and reinvested in the business. The authors in this edition have not attempted to abandon completely the use of the term earned surplus, but they recognize the force of the arguments in favor of replacing it with a more precise term.

CAPITAL SURPLUS.—The term "capital surplus" has been used to describe any type of surplus other than earned surplus. But if surplus is merely one form of capital, the term capital surplus is redundant; if "surplus" is used to indicate capital derived from the conduct of the business, the term capital surplus is in conflict with the term earned surplus. The confusion surrounding the use of the term capital surplus has resulted in many accountants recommending that its use be discontinued; and that it be replaced (as the authors have endeavored to do in this book) by terms which may be used to describe the source of the excess of contributed or other invested capital over par or stated value of capital stock. Among the sources of surplus, other than that retained in the business from profits, which may be more specifically described, are those indicated in following sections.

Paid-in Surplus.—The term "paid-in surplus" usually means capital contributed by stockholders in excess of par or stated value of capital shares. The following conditions are characteristic of those wherein this surplus arises:

1. Sales of par value capital stock at prices or for consideration in excess of par, which excess is known as premium on capital stock;

2. Sales of no par stock in which part of the proceeds is designated as the stated value of capital stock and the remainder is allocated to paid-in surplus. The consideration received by the corporation may be in the form of cash or property;
3. The reduction of the par or stated value of previously issued capital stock. This credit may be best described as "surplus arising from reduction in par (or stated value) of capital stock."

Other sources of surplus, similar in many respects to paid-in surplus, are donated surplus, surplus arising from stock assessments, from forfeited stock subscriptions, and from the sale or retirement of treasury stock.

Donated Surplus.—When a corporation's own stock (issued fully paid and nonassessable) which has been reacquired by donation is subsequently disposed of, the proceeds of the sale may be described as donated surplus.

Donated treasury stock may be entered on the books at $1, with an offsetting credit to donated surplus; the proceeds from the sales of such stock should be credited to donated surplus, and the treasury stock account eliminated after all the shares have been sold. If, for good reason, it seems desirable to record donated treasury stock at its par or stated value, the credit is to donated surplus. The latter account may be adjusted if the shares are subsequently disposed of at prices different from par or stated value.

Stock Assessments.—Although most shares of stock are fully paid and nonassessable, corporations occasionally levy a voluntary pro rata assessment on all shares outstanding. This levy is usually made when the corporation is facing bankruptcy or is undergoing a reorganization. Since it results in an increase in the capital funds of the corporation, surplus, adequately described, should be credited with the excess of the total consideration received, including both the original sales price and the assessment, over the par or stated value of the stock.

Forfeited Stock Subscriptions.—When a subscriber to capital stock remits a portion of the subscription price and fails to pay the balance, the corporation must act in accordance with the laws of the state of incorporation. In some states, the subscriber, after a certain period of time has elapsed, forfeits his payment, and the corporation may resell the stock. If the stock is resold at an amount which,

together with the amount forfeited, exceeds par or stated value, a form of paid-in surplus arises.

Retirement or Sale of Treasury Stock.—In most states the excess of par or stated value over cost of treasury stock retired or deemed not reissuable should be credited to a surplus account such as paid-in surplus. Likewise, when the accounting treatment recommended by the Committee on Accounting Procedure of the American Institute of Accountants is followed, profit on the resale of treasury stock should be similarly classified.

Surplus in Mergers or Acquisition of Subsidiaries.—When two or more corporations merge, the owners may assume that the old entities are continuing in a slightly different form and that the combined earned surplus of all will form the aggregate earned surplus of the new entity. This is true if the state law permits the "emerging" corporation to be a continuance, but when a merger results in a new corporate entity, there is no legal continuance and surplus carried forward usually thereafter should be described as paid-in surplus.

When there is a merger of a subsidiary with a parent company, it is permissible accounting practice to include in the earned surplus of the parent company the surplus of the subsidiary earned and not distributed since date of acquisition by the parent. Similarly, if two companies owned by the same parent are merged, say, by the issuance of additional stock of one company in exchange for the stock of the other, with subsequent merger of the resulting subsidiary with the parent, the earned surplus of this subsidiary may be taken over as such by the parent company.

When a corporation wishes to change its domicile to another state and for that purpose a corporation is formed in that state with the same corporate powers and capitalization to acquire the business of the first corporation, it is permissible for the new corporation to take over the earned surplus of its predecessor.

If the effective date specified in an agreement for corporate merger or for purchase of a going business is prior to the actual date of passing of title to the properties, it may be practicable to consider that the earned surplus and operations of the new (successor) enterprise begin from the earlier date. Use of the earlier date is not objectionable if changes in surplus in the interim period are not significant.

Revaluation Surplus.—Revaluation surplus may arise when the assets are stated on a basis higher than cost.

If the higher amount based on an appraisal can be shown to be due to excessive provision for depreciation or charges of capital items to maintenance, the excess may be carried to earned surplus and appropriately explained. If, however, the new amount has arisen from an appreciation in value or unearned increment, the excess should not be credited to earned surplus but to "surplus arising from appreciation."

In Chapter 13, the viewpoint of the Committee on Accounting Procedure (Bulletin No. 5) was stated with respect to basing depreciation charges on the higher appraisal amounts rather than on cost; the committee did not, however, express an opinion as to the ultimate disposition, if any, that is to be made of the appraisal surplus.

Other Transactions Affecting Surplus Other Than Earned Surplus.—In accordance with generally accepted accounting principles, some items may be properly charged or credited to surplus other than that represented by net income retained in the business. The principal transactions which may be so treated are discussed below.

Dividends.—Dividends may be paid out of other than earned surplus when permitted by statute and authorized by the directors. Dividends on partial or complete liquidation and stock dividends are sometimes paid out of such surplus. For a further discussion of dividends, see the latter part of this chapter.

Transactions in Treasury Stock.—Disposition of profit on resale of treasury stock has been treated on page 385. Loss on the sale of treasury stock may be charged to surplus arising from similar transactions; if no such surplus exists usually the charge should be to earned surplus. It would be improper to charge a loss on the sale of treasury stock to paid-in surplus arising from an outstanding issue of capital stock, but it would be proper to charge such a loss to a paid-in surplus account from a class of stock or shares no longer outstanding.

Organization and Financing Expenses.—Organization expenses of newly formed corporations are sometimes charged to paid-in surplus arising from the sale of stock at a premium, provided the directors authorize and the laws of the state of incorporation permit such a charge. The more usual method of disposing of organization expenses is to charge them to earnings over a short period, such as three years, or to earned surplus after the business begins to accumulate profits.

Expenditures and write-offs incident to reorganization or recapitalization are usually charged against paid-in surplus resulting from the reorganization.

Selling expenses and commissions on issues of capital shares may be charged against paid-in surplus created from proceeds of the issue, against paid-in surplus created from proceeds of issues or shares no longer outstanding, or against earned surplus. These selling expenses and commissions may include commissions to selling agents; commissions or discounts allowed to underwriters; attorneys', engineers', or accountants' fees; printing costs; S.E.C. filing fees; and other expenses clearly and directly attributable to realization of proceeds of the shares issued.

Quasi-reorganizations.—A quasi-reorganization has been defined as "a procedure recognized in accounting by which the accounts of a corporation may be restated to the same extent as they properly would be if a new corporation were created and acquired the business of the existing corporation. A quasi-reorganization establishes a new basis of accountability for assets and liabilities."

In 1934, on recommendation of the special committee on cooperation with stock exchanges, the American Institute of Accountants formally adopted the following rule relating to surplus other than that arising from profits retained in the business:

> Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

In Accounting Research Bulletin No. 3, issued in September, 1939, the Committee on Accounting Procedure dealt with the quasi-reorganization as a means of accomplishing the readjustment referred to in the above rule. The following is a summary of the requirements then established:

> 1. Restatements proposed in a quasi-reorganization should be clearly reported to stockholders and their formal consent to the restatements should be obtained.
>
> 2. The readjustment should result in a fair and conservative balance sheet as at the date of the readjustment with assets and liabilities

so stated that no artificial debits or credits will thereafter arise. The readjustment of values should be substantially complete, and when accomplished the accounts should be substantially similar to those appropriate for a new company.

3. The effective date of the readjustment should be as near as practical to the date of formal consent of stockholders and should ordinarily not be prior to the close of the last completed fiscal year.

4. Amounts charged off should be charged first against earned surplus to the full extent thereof; the balance may then be charged against capital surplus.

5. A new earned surplus account should be established and described as being accumulated from the effective date of the readjustment.

A number of corporations during the early 1930's recorded downward revisions of assets, restatements of capital stock, and absorption of operating deficits in accordance with the above rules.

It is implicit in a quasi-reorganization that there should be no remaining balance of earned surplus and that no deficit should exist in any surplus account. This is in accordance with the principle that the organization resulting from the quasi-reorganization is, in effect, a new entity and not merely a continuation of the former company. It is not expected that quasi-reorganizations be repeated at frequent intervals, if at all. The Securities and Exchange Commission has suggested (Accounting Series Release No. 15) that after restatement of surplus "until such time as the results of operations of the company on the new basis are available for an appropriate period of years (at least three) any statement or showing of earned surplus should, in order to provide additional disclosure of the occurrence and the significance of the quasi-reorganization, indicate the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been required to be made against income or earned surplus."

Material transactions occurring after the quasi-reorganization which relate to the prior period should not be reflected in the new earned surplus account. Indeterminate charges at the date of quasi-reorganization may be set up with corresponding credits to reserve accounts which will absorb these charges as they occur. If the reserves set up are excessive and are not needed in later periods, they should be returned to paid-in surplus, never to surplus earned since the quasi-reorganization date.

Dividends received from subsidiaries after the quasi-reorganization out of earnings prior to the adjustment represent capital adjustments and not credits to income. Earned surplus of subsidiaries at

the date of quasi-reorganization should not be carried forward as earned surplus in the consolidated balance sheet.

Charges for Reduction of Amounts of Fixed Assets and Securities.—Sometimes paid-in surplus, representing either an amount already appearing on the books or created by reduction in par or stated value of capital stock, is utilized for absorption of certain losses, even though there exists concurrently a balance of earned surplus. These charges frequently represent reductions in the amounts at which securities are carried in the portfolios of investment trusts or reductions of book amounts of fixed assets of industrial companies.

If assets at demonstrably overstated amounts have been acquired in exchange for capital stock and a portion of these amounts is reflected in paid-in surplus, it may be permissible to eliminate such part of the excessive amount as is represented in paid-in surplus by charges against that account. When the assets to be written down were acquired for cash or its equivalent, or were received for stock as fair value at date of acquisition, a subsequent reduction in book amount represents a loss and should be charged to earned surplus directly or through the income statement.

When there is preferred stock outstanding and the state laws under which the corporation is organized permit the payment of dividends on preferred stock out of paid-in surplus when there is no earned surplus against which such dividends can be charged, charging reductions of fixed assets or security amounts to paid-in surplus may be inadvisable under certain circumstances. If assets are written off against paid-in surplus, the subsequent exhaustion of earned surplus through dividends to common as well as preferred stockholders may deprive preferred stockholders of their right to receive dividends from paid-in surplus, whereas such rights might not be endangered if the amounts written off were charged against earned surplus and the directors limited common dividends to available earned surplus.

Premium and Call Expense on Redeemed Issues.—Preferred stock agreements often permit the issuing corporation to call the issue for retirement subject to the payment of accrued dividends and a premium over the par or stated value of the issue. Call expense represents expenses connected with its retirement.

In general, premium and call expense on stock, which has preference in involuntary liquidation to the extent of par or stated value when called and redeemed, should be charged to earned surplus. Under certain circumstances, however, premium and call expense, in whole or in part, may be charged to paid-in surplus.

If, upon the original issue of the shares a premium over the par or stated value was received and credited to paid-in surplus, premium and call expense on retirement may be charged to paid-in surplus to the extent of the premium received. If less than the entire issue is redeemed, such paid-in surplus should be charged only with the portion applicable to the shares retired. Paid-in surplus resulting from sources other than an issue or shares no longer outstanding should not be used to relieve earned surplus of such charges.

When a new issue of preferred or common stock is sold at a premium for the purpose of securing funds to retire an old issue of preferred, the premium and call expense may be charged first to any paid-in surplus applicable to the old issue and then to the premium on the new stock to the extent it exceeds the call price on the new issue.

Appropriated Surplus.—Since surplus other than earned surplus is usually a permanent part of the capital of the business, appropriations are usually made from earned surplus only. The directors at any time may set aside from such surplus an amount representing an undivided portion of the assets to be held or retained for general or specific purposes. Examples of such segregations are sinking fund reserves, reserves for retirement of preferred stocks, for working capital, for extraordinary obsolescence, and for general contingencies.

Some of the more important types of surplus reserves are discussed below.

Sinking Fund Reserves.—Many issues of bonds, notes, and preferred stock contain stipulations which impose limitations on a portion of earned surplus. The underlying purpose is to limit or prevent the payment of dividends on junior securities. In bond and note agreements, the intention is to limit or prevent dividends on stock; in preferred stock agreements, the intention is to limit or prevent dividends on common stock. This intention may be defeated unless surplus available for dividends is reduced by the full amount of reserves set aside to retire bonds, notes, or stocks until the full purposes of the requirements are met.

Reserve requirements may be based upon realizations of wasting assets; fixed installments, i.e., specific sums or specific percentages of outstanding issues; or a stated percentage of net profits. There are many other bases. It is not necessary to enumerate the reasons for, and the importance of, providing the reserves, as such reasons differ according to the terms of the agreements under which the securities are authorized and issued. It is not enough that accounts be set up

for sinking fund and retirement reserves, the subsequent treatment of the accounts is of equal importance. The requirements of some agreements are ambiguous, but a correct understanding of the intention of the investors (as well as the intention of the corporation) is of great importance.

While the setting up of this type of reserve is a convenient device for measuring, with respect to the undistributed earnings, the assets which have been devoted to retirement or acquisition of the related securities, the procedure cannot be considered as a guaranty, of itself, that the requisite assets will be available when needed in the form required; hence, retirement or sinking fund reserves are sometimes accompanied by the segregation of cash or other assets to insure a liquid position when the obligations mature.

It is generally understood that when agreements require such segregation of assets "out of earnings" and it is the intention that such earnings should be retained in the business, it is necessary to maintain a surplus reserve equivalent to the cumulative total of the fund or assets set aside. Interpretation of the controlling agreements is, however, a legal matter and the auditor should consult counsel unless the intention of the agreements is clear.

Even though the reserve account, because of periodic retirements, may exceed the principal amount of the issue remaining to be retired, it is not usually proper to transfer any part of the reserve to general surplus until the issue has been completely retired, unless the original agreement so provides or unless the original agreement has been modified by unanimous consent of the interested parties. On retirement of the entire issue, the reserve may be returned to surplus.

Reserves for Retirement of Preferred Stock.—Under the terms of agreements to retire preferred stock, a portion of surplus may be appropriated annually to prevent dissipation of assets by means of dividends on common stock. Some contend that, when any portion of the preferred stock is retired, the surplus which had been segregated for that purpose should be restored to earned surplus. Others hold that the reserve should be maintained intact until the entire issue is retired. The latter treatment is essential if the reserve is intended as full protection to the preferred stockholders. The restoration of any portion of the reserve to earned surplus prior to the completion of retirement of the total related issue of securities makes possible the distribution to the common stockholders of an equivalent amount of available assets out of the accumulated earnings of the past. Such a distribution reduces the corporation's working capital and in effect,

results in using the same earnings twice; once to reacquire the securities retired, and again, as the basis for dividends.

Reserves for Working Capital.—The segregation from earned surplus of a reasonable amount as a reserve for additional working capital may be temporary or permanent, as the directors determine. A reserve for working capital is not a liability, because at any time the directors may transfer the entire balance to unappropriated earned surplus and pay out all or any part of it in dividends. The account is a voluntary and revocable segregation of surplus. It may be necessary to accumulate a substantial surplus and if the directors believe that the temptation to declare dividends is less if the surplus account is diminished and some other surplus account with a different name is created, this segregation is permissible. Such segregation of profits should have directors' approval.

Reserves for Fires and Similar Losses.—Corporations which are self-insurers usually carry reserves for losses. Balances of these reserves constitute segregated surplus, provided of course that damages sustained or losses incurred have been taken care of or are recorded as accrued liabilities. Any further loss or damage is merely a possibility, the eventuality of which cannot be foreseen.

Reserves for Future Inventory Declines.—Even if inventories are fairly stated at the lower of cost or market, management may feel that prices may go lower, and accordingly may segregate a portion of surplus as a conservative measure. The account may be entitled "Reserve for Future Inventory Decline" or otherwise described. Such a reserve should not be used to absorb inventory losses and when it no longer seems desirable to so segregate a part of surplus, it should be returned to earned surplus.

Reserves for Employee Pension Plans.—In recent years, many companies have adopted pension plans for retired employees. These plans may be either revocable or irrevocable. If irrevocable, they are generally handled through an insurance company. Even if the plan may be revoked by the management without any legal consequences, the company will probably feel that in the interest of good labor relations it is morally bound to pursue the plan indefinitely. Sometimes surplus is segregated as a reserve for employee pensions in which event the purposes of the reserves should be clearly set forth, usually in a note to the financial statements.

Secret Reserves.—A corporation's capital is sometimes understated, usually intentionally, though occasionally inadvertently,

through the creation of secret reserves. This term denotes the existence of proprietary equities concealed through the understatement or omission of assets, the overstatement of liabilities, or the inclusion of fictitious liabilities.

From an accounting standpoint, there appears to be no justification for flagrant undervaluation of net assets in any circumstances. Nevertheless, the practice has occasionally been supported. The principal argument used in support of secret reserves is that stockholders are notoriously insistent upon dividends and that in the stockholders' opinion a surplus available for dividends but not so distributed is not evidence of good management. On the other hand, if profits of good years are distributed in their entirety, there is bitter criticism when the inevitable poor year arrives and the dividend must be passed. There is little merit to the argument in favor of secret reserves when contrasted with the advantages of presenting fairly asset and liability amounts in accordance with accepted accounting principles.

It is apparent that a stockholder who desires to sell and fixes a price upon his stock based on reported earnings is at a great disadvantage as compared with a prospective purchaser who knows that the full earnings are not reported and that a part of the profit is diverted to a secret reserve with which it is proposed to bolster up any unusually unprofitable subsequent period.

General Purpose Contingency Reserves.—Management may set up general purpose contingency reserves which are not required at the time under generally accepted accounting principles and whose purposes are not specific. Such reserves are those created:

1. For general undetermined contingencies,
2. For a wide variety of indefinite possible future losses,
3. Without any specific purpose reasonably related to operations for the current period, or
4. In amounts not determined on the basis of any reasonable estimates of costs or losses.

Charges and credits to these reserves should not enter into the determination of net income.

Accounting Research Bulletin No. 28, issued in July, 1947, considers these reserves and its recommendations as modified by Bulletin No. 35, issued in October, 1948, may be paraphrased as follows:

1. Provisions for such reserves should not be included as charges in determining net income.

2. When such a reserve is set up it should be created by a segregation or appropriation of surplus.
3. Costs or losses should not be treated as charges to such reserves and no part of such a reserve should be transferred to income or in any way used to affect the determination of net income for any year.
4. When such a reserve or any part thereof is no longer considered desirable it should be restored to surplus.

Capital of Businesses Other Than Corporations.—Business organizations other than corporations range from individual proprietorships to organizations tantamount to corporations. The more common types are individual proprietorships, business partnerships, limited partnerships, partnerships with transferable shares, and Massachusetts voluntary trusts with transferable shares. The last type mentioned so closely resembles a corporation that it is taxed like one.

As in a corporation, the types of capital and the rights of participants in a business depend upon the laws of the state in which it is formed and the articles of partnership or association.

Capital of Nonbusiness Enterprises.—Nonbusiness enterprises include such organizations as churches, fraternal orders, educational institutions, hospitals, and clubs. They may adopt one of several forms of legal organization, but usually there are no stockholders. In general, they are not subject to taxation.

The capital of these enterprises represents mainly donations, which may be in the form of cash contributions, legacies, or endowments. The trustees may be permitted to use earnings from the funds and the funds themselves at their discretion, but often donors place restrictions upon both income and principal.

The accounting for capital in these enterprises may not follow generally accepted accounting principles in all respects. Legal restrictions placed upon the discretion of the trustees may require accounting treatment differing from that found in business enterprises. For example, profits or losses on the sale of stocks or bonds may be considered as changes in capital rather than credits or charges to income.

INTERNAL CONTROL

Capital Stock.—The extent of a corporation's internal control over its capital stock will vary depending on whether an independent transfer agent and a registrar are employed. Corporations with stock

listed on an exchange in accordance with listing agreements are required to maintain a transfer office or agency and, in addition, a registrar other than the transfer agent. When stocks are not listed but are widely held and transfers are numerous, independent agents are frequently employed.

A transfer agent is responsible for maintaining stockholders' records, approving transfer instruments, and issuing new stock certificates. A registrar controls the issues of stock and registers stock as issued.

The use of these agents facilitates the recording of transfers, relieves the corporation of considerable detailed record keeping and the responsibility for its accuracy, minimizes the possibility of fraud or error, and reduces the possibility of incurring penalties in connection with stock transfers resulting from inadequate knowledge or facilities. Stock certificates should be delivered to these agents only on specific authorizations of a designated official of the company.

More exacting controls are required when these agents are not employed. Among the more important procedures of internal control are the following:

1. Blank stock certificates and stubs should be prenumbered and issued in numerical sequence. When a certificate is surrendered it should be canceled effectively and the canceled certificate attached to its original stub. The officer authorized to sign stock certificates should be designated by the Board of Directors.

2. Adequate records should be maintained, including stock ledgers, transfer journals, window tickets, registers of certificates received, ledger and stock control records, stop transfer records, and registers of authorized signatures. These records should be kept by persons other than those preparing the documents for issue and cancellation.

3. Subsidiary records should be balanced periodically with controlling accounts.

4. The signing or countersigning of certificates in advance should be prohibited.

5. Security certificates of all types should be stored in suitable vaults and handled by authorized personnel only. Numerical accountability should be maintained and unused certificate books should be examined periodically for possible unauthorized extractions. This control should be maintained when stock certificates are accessible to personnel of the corporation, even when the issuance is under the control of a registrar.

6. Treasury stock should be in the company's name and physically segregated from other security certificates.

7. Lost certificates should be replaced only after approval of the Board of Directors, and receipt of an affidavit of loss accompanied by an indemnity bond.

8. Transfer stamps should be controlled by the use of a special imprest fund.

9. When an internal audit staff is maintained, a surprise audit of the transfer department should be included in its program.

Surplus and Surplus Reserves.—All unusual entries in the surplus and surplus reserve accounts should be approved by the Board of Directors.

Periodically, analyses of surplus and surplus reserve accounts summarizing all changes in these accounts should be reviewed by a company official, preferably the comptroller or chief accountant.

AUDITING PROCEDURES

Capital Stock.—In an initial examination, the auditor should study the corporation's charter or certificate of incorporation and the by-laws and all pertinent amendments; review minutes of meetings of the Board of Directors and stockholders and other documents; and analyze the capital stock accounts. In subsequent examinations, only changes occurring within the period under examination need be reviewed.

When capital stock of the company has been sold to the public, it is also advisable to review agreements with underwriters and others and the prospectus filed with the S.E.C. These sources may reveal provisions not indicated elsewhere, such as those for maintenance of minimum working capital or minimum earned surplus.

The auditor should include in his permanent file of working papers information as to the kinds of stock authorized, the number of shares of each class authorized, par or stated values, provisions concerning dividend rates, redemption values, priority rights to dividends and in liquidation, cumulative or noncumulative rights to dividends, participation or conversion privileges, and other pertinent data.

If there is an independent transfer agent, the number of shares outstanding at the balance sheet date should be confirmed with him. If there is a registrar, a similar confirmation should be obtained from him.

Some accountants advocate correspondence with the Secretary of State of the state in which the client is incorporated, to obtain direct confirmation of the number of shares and classes of capital

stock authorized. This procedure is advisable on a new engagement; it is often followed in others when there are indications that minute books and other corporate records do not contain a complete record of changes in originally authorized capital stock.

Unpaid subscriptions should be substantiated as to the number of shares and amounts by reference to subscriptions on file or other supporting documents. If stock has been sold on the installment plan, the auditor should ascertain that collections have been received in accordance with the terms of the sale. If special terms have been granted to any stockholder, such action should be approved by the Board of Directors.

The auditor should compare the number of shares outstanding and subscribed for, as evidenced by his examination of the stock certificate stubs, stockholders' records, subscription records, and confirmations, with the ledger accounts and with the certificate of incorporation and its amendments, to ascertain that the number of shares of each class of stock issued and subscribed for is properly reflected in the books of account and is within the amount authorized. In his examination of stock certificate books, the auditor should be alert to evidence which may indicate the issuance of certificates, without proper approval and record on the stock certificate stubs.

Proceeds from the sale of capital stock shown by the records to have been issued should be traced to the accounts. If stock has been issued for property or assets other than cash, the minutes of the corporation should state the authorized basis of the exchange.

The auditor cannot assume responsibility for determining that the stock issued is legally fully paid, but he should familiarize himself generally with the provisions of the laws of the state in which the company is incorporated relating to the legal consideration for an issue of capital stock. Reference to requirements in issues of no par stock and the repurchase of the client's own stock are especially important. In many states, promissory notes or future services are not acceptable as payment or part payment for the issue of capital shares. If the auditor has any doubt as to the legality of the consideration for stock issued, he should ask the client to obtain opinion of counsel on the point. The balance sheet treatment of stock determined by counsel to be in fact not legally fully paid requires careful consideration.

When large corporations maintain their own transfer departments, the auditor may make a surprise examination of this department. This examination may include a count of all securities on

hand, checking of all transactions for a selected period, and examination of correspondence files.

Options and Warrants.—The auditor should ascertain that transactions concerning options and warrants have been properly recorded, and that options and warrants are exercised in compliance with the terms of their issue.

Treasury Stock.—Certificates for shares reacquired and in the treasury should be examined and compared with entries in the treasury stock account. Treasury stock should be in the name of the company, endorsed to the company, or accompanied by a properly executed power of attorney. If treasury stock is not in the possession of the corporation, confirmation should be requested from the custodian. Transactions in treasury stock should be examined as to their propriety and as to consistency of accounting treatment.

Federal Stamp Taxes on Original Issues of Capital Stock.—The federal government and some states impose a stamp tax on each original issue of stock and the auditor should assure himself that the tax has been paid by noting that the proper stamps have been affixed to the certificate stubs. If the stock records are in charge of independent agents, reference may be made to cash records for assurance as to payment of the original issue taxes.

Records on File in Public Offices.—In most states it is possible to ascertain from public records the powers and purposes of the corporation, the kinds and amount of capital stock or obligations authorized for issue, the rights of the holders of the various kinds of securities, provisions for sinking funds, and redemption and conversion features of each issue. While most of this information should be found in the records of the corporation, the official public records may be of value as collateral evidence. As a general rule auditors are justified in relying on information which they obtain from the corporate records.

Treatment of Unexchanged Capital Stock in Recapitalizations.—When a corporation is recapitalized, new shares of a different par value or with different provisions are often exchanged for shares presently outstanding. After the final date for making the exchange or the expiration of the period during which the old shares may be traded on a security exchange, some of the old shares still may be outstanding. The auditor should examine the recapitaliza-

tion plan and available data to ascertain that exchanges were made in accordance with the terms of the plan and that accounting was proper. He should satisfy himself as to the number of shares unexchanged after the final exchange date and see that proper reference is made to them in the financial statements.

Surplus.—When an audit is being conducted for the first time, the auditor should analyze the surplus accounts from the date of the first entry in order that he may determine whether all entries seem to be in accordance with generally accepted accounting practice. The basis for the origin of such surplus accounts as Revaluation or Donated Surplus, their authorization, and valuations set up on considerations other than cash should be carefully scrutinized by the auditor. Entries to these accounts should also be reviewed as to consistency of treatment from year to year. This analysis of the surplus accounts should be retained in the auditor's permanent file of working papers in order that the propriety of the current year changes may be readily reviewed for consistency in treatment.

All surplus reserves should be similarly analyzed and reviewed. The creation of new reserves and changes in existing reserves should be checked to authorizations in the minutes of the Board of Directors' meetings. Entries in the surplus reserve accounts should be checked as to conformity with the purposes of the reserves.

Minutes of the meetings of directors and stockholders should be examined for authorizations of transactions that have been or should be recorded in the surplus and surplus reserve accounts. For example, when capital surplus has been created or increased by reducing the par or stated value of outstanding capital stock, such action may require the approval of the stockholders and directors.

When subscribers to capital stock have not paid their subscriptions in full and part payments have been credited to surplus, the auditor should satisfy himself, usually by inquiry of counsel, that the corporation has a legal right to retain the amounts paid in.

Secret Reserves.—Secret reserves usually arise when generally accepted accounting principles have not been followed, as when costs of fixed assets are charged to income as maintenance, excessive allowances are made for depreciation, inventories are understated, assets are improperly written down or omitted, or liabilities are overstated. The auditor's procedures are designed to disclose any material departure from the application of generally accepted accounting principles which may result in secret reserves.

Individual Proprietor's Capital.—In an individual proprietorship there will seldom be formal documents with respect to capital paid in. The excess of assets over liabilities at any given date represents the proprietor's capital. Changes in capital between one audit date and another should be analyzed and substantiated. It is desirable to summarize the changes in capital between balance sheet dates in order that those interested may readily determine the results of operations as distinguished from capital contributions and withdrawals.

Partnership Capital.—As part of his examination of partnership accounts, the auditor should read the partnership agreement. Ordinarily these agreements not only show the basis on which profits and losses shall be shared but also contain provisions relative to fixed amounts of capital to be maintained by the various partners, loans by partners in certain circumstances, interest on partners' capital and loans, limitations on withdrawals, and similar matters. The auditor should analyze and substantiate changes in partnership capital between audit dates, report failure to carry out provisions of the partnership agreement, and suggest adjustments necessary to reflect them correctly in the books.

Some partnerships conduct business without written partnership agreements. In these circumstances the auditor should determine whether the partners understand the basis on which the accounts are kept, particularly with respect to distributions of profits or losses and interest on partners' capital. Perhaps the most effective way to do this is to have each partner sign the financial statements on which the partners' accounts appear. An alternative procedure is to have the partners confirm the balances in their accounts.

If partners' withdrawals are made in currency, partners should approve their accounts as they appear in the ledger. The practice of permitting drawings of small amounts at frequent intervals without evidence of receipt is an invitation to dishonesty on the part of the cashier. Auditors should criticize the practice and suggest to partners that withdrawals be by check only and that personal bills be paid through their personal bank accounts.

Capital of Nonbusiness Organizations.—For organizations of this nature the auditor should consider procedures similar to those previously discussed, where appropriate. The terms of donations or bequests should be examined.

The auditor should review changes in capital between balance sheet dates and make such tests as appear advisable in the particular

situation to assure himself that items which are required to be disposed of in accordance with articles of organization or incorporation, or resolutions by the trustees, directors, or members as embodied in the organization's minutes, have been so handled as to give effect to the terms of the specific provisions.

Time of Examination.—The auditor's examination of capital stock and surplus accounts cannot be completed until the close of the fiscal period under review. However, when these accounts are active, the auditor may make preliminary analyses and review the accounts prior to the end of the year, bringing his examination up to date after the close of the period.

STATEMENT PRESENTATION

Capital of Business Corporations.—It is important that capital be so stated that each stockholder and prospective investor may have a clear picture of the capital structure of the company.

Capital stock should be the first item in the capital section of the balance sheet. If there is more than one issue of stock, the several classes should be stated in the order of the priority of their rights in liquidation, which is usually the same as the order of priority in participation in earnings. Under this standard, preferred stock is usually stated first. The description of each issue of stock should include its legal title; whether it is par or no par value stock and the par value per share or, if no par value, the stated or assigned value per share, if any; the number of shares authorized; the number and aggregate dollar amount of shares issued and outstanding; and, if preferred stock, the nature of the preference, the dividend rate, whether cumulative or noncumulative and, in circumstances later discussed, the redemption and liquidation amounts. If shares of any class of stock are reserved for issue on conversion of other classes of stocks or of bonds, the facts should be stated in the description of the issue reserved or in a note to the balance sheet.

No par value stock is variously stated on balance sheets. Some statements do not differentiate between amounts contributed by stockholders and accretions resulting from earnings, indicating capital and surplus, variously captioned, in one amount; i.e., usually the number of shares of each class of stock is indicated, in the body of the statement or in a footnote, without amounts. This presentation is unsatisfactory because it does not provide stockholders and investors with information about the statutory capital of the company and the rights of different classes of stockholders.

State laws may require that a minimum value be ascribed to no par value shares. However, this is only a minimum value; if the corporation has ascribed a higher value, it should be shown opposite the caption "capital stock."

Many stock agreements contain restrictive and preference provisions. In addition to obtaining full details of the issues, the auditor should make certain that the balance sheet describes adequately the various classes of stock so that owners of junior securities may ascertain what prior liens exist as to dividend distributions, redemptions, and in liquidation.

Redemption or Liquidating Prices Above Par or Stated Values.—When redemption or liquidating prices of preference stocks are above their par or stated values, the facts should be clearly set forth in order that holders of junior shares may realize the extent to which surplus will be reduced if senior issues are retired or the company is liquidated. It is good practice to indicate in dollars the aggregate excess of involuntary liquidation price of preference stock over par or stated value.

The Securities and Exchange Commission's Regulation S-X requires that, if "the excess involved is significant there shall be shown (1) the difference between the aggregate preference on involuntary liquidation and the aggregate par or stated value; (2) a statement that this difference, plus any arrears in dividends, exceeds the sum of the par or stated value of the junior capital shares and the surplus, if such is the case; and (3) a statement as to the existence, or absence, of any restrictions upon surplus growing out of the fact that upon involuntary liquidation the preference of the preferred shares exceeds its par or stated value." As administrative policy the Commission has also required, when the excess involved is significant, an opinion of counsel as to whether there are any restrictions upon surplus by reason of these differences and also as to any remedies available to stockholders before or after the payment of any dividend that reduces surplus to an amount less than that by which the aggregate preference of such stock on involuntary liquidation exceeds its aggregate par or stated value.

Many companies show on the balance sheet no par preferred stock at the amount of preference in liquidation rather than at a lower amount paid in or at a lower legal stated value. The difference has been charged either to paid-in surplus or to earned surplus. Some contend that this excess should be charged against the amount paid

in on the common stock, but in the authors' opinion it should be charged first against surplus, if any, paid in on the particular no par preferred stock and the balance against earned surplus. One alleged advantage of stating no par preferred stock at the amount of preference in liquidation is that it simplifies the evaluation of the common stock since all of the surplus, except that which may be applicable to dividends on preferred stock, is then identified with the common stock. Another advantage claimed is that it obviates the possibility of surplus being reduced by subsequent dividend declarations below the amount required to preserve the liquidation value of the preferred stock. This method of stating preferred stock may be open to criticism because it states one class of stock on a liquidation basis (which closely resembles the par which the creation of the no par stock was designed to avoid) while another class of stock is shown on a going-concern basis. If the client wishes to state no par preferred stock on the balance sheet at the amount of preference in liquidation and this is permitted by the statutes of the state in which the company is incorporated, the auditor should offer no objection providing the issue is adequately described.

Dividends in Arrears.—When unpaid dividends on preferred stock have accumulated, the amount unpaid, or the date since which unpaid dividends have accumulated, should be stated in the balance sheet. The Securities and Exchange Commission requires that "arrears in cumulative dividends per share and in total for each class of shares shall be stated." This information may be indicated in a parenthetical note in the description of the preferred stock or in a note to the balance sheet.

Discount on Capital Stock.—In many states the issuance of capital stock at a discount imposes a liability on the holders of such shares to creditors of the corporation in the amount of the applicable discount. The discount is of interest chiefly to creditors should the corporation get into financial difficulties.

On the balance sheet, discounts on capital stock other than preference shares generally should be deducted from the capital stock to which it relates. It may be deducted from the total of capital stock and surplus. If part of a class of stock is sold at a discount and the balance at a premium, discount and premium may be offset against each other with disclosure that this offset has been made.

Regulation S-X of the Securities and Exchange Commission contains the following rule of general application:

> Discount on capital shares, if significant in amount, shall be shown separately as a deduction from capital shares or from surplus, as circumstances require, with an indication of what provisions have been made for writing off this item.

When the discount applies to preference shares, it is good practice to show the item as a deduction from paid-in surplus arising from other sales of the same issue or from earned surplus. There is no logical reason for writing off the discount periodically by charges to income.

Unexchanged Stock in Recapitalization.—No hard-and-fast rule can be laid down with respect to the presentation in the balance sheet of the unexchanged capital stock after the date of recapitalization. Usually the new capital stock should be shown as though all the old shares had been exchanged, with an explanatory comment either in the body of the statement or as a footnote stating the number of old shares still outstanding which for balance sheet purposes are assumed to have been exchanged and the basis upon which the exchange will be made upon receipt of the old certificates.

Subordinated Indebtedness Treated as Capital.—Corporations sometimes issue long-term debentures with provisions subordinating them to other corporate obligations. These are frequently issued to stockholders who may be willing to accept a subordinate position. In some instances, the interest on the debentures is payable only if earned and is noncumulative. If only common stock is outstanding, these debentures, on liquidation of the company, have substantially the standing of preferred stock.

Debentures of this type are sometimes classified with capital rather than as corporate liabilities. Ordinarily there should be no objection to such presentation provided full disclosure is made. On a balance sheet illustrative of this treatment, the capital section is headed "Capital and subordinated debentures" and the debentures listed first may be described as here illustrated:

> Twenty-year 6% Debentures, due August 1, 1966, redeemable in whole or in part at the option of the corporation on 90 days' written notice at par and accrued interest but subordinate, in the event of liquidation, in every respect to claims of creditors.

Stock Warrants and Options.—Stock warrants and options granted should be adequately disclosed on the balance sheet, whether or not value has been received by the granting corporation, so that stockholders may know to what extent potential purchasers have

options on stock which otherwise would be available for sale or issue. When option rights have been issued to officers and employees as compensation for services, the amount determined to be compensation should be shown in the capital section of the balance sheet in a manner similar to that for proceeds from subscriptions for capital stock. As the options are exercised, this amount will be relieved by transfer of appropriate amounts to a capital stock account and, possibly, to a surplus account other than earned surplus, adequately described.

Treasury Stock.—The balance sheet should indicate the number of shares of stock held in the treasury and describe the issue. Treasury stock is usually deducted from capital, but if it has been acquired for the specific purpose of resale to employees or others, it is permissible to show it separately on the asset side of the balance sheet, at cost; the reason for the treatment should be disclosed in a note to the balance sheet.

The laws of many states provide that treasury stock may be purchased only when the purchase does not impair legal capital; in some states surplus available for payment of dividends or other purposes is restricted in the amount of the cost of treasury stock. Present-day practice generally is to show treasury stock on the balance sheet at cost, deducted from the total of capital stock, other paid-in capital, and earned surplus; if the state law indicates that an equal amount of surplus is then restricted, the fact should be disclosed in a note to the financial statements.

Formerly it was not uncommon to display treasury stock "as if" it were retired; the par or stated amount of treasury stock was deducted from capital stock, and the difference between cost and par or stated value was adjusted through the appropriate surplus account. For most states, this procedure reflected the situation as it would have been if the legal steps necessary for retirement of treasury stock had actually been taken. A serious objection to this method is that it does not indicate the possible effect on surplus of the restrictions arising from acquisition of treasury stock and therefore it is not now considered the best practice.

Legal considerations must have substantial weight in determining the proper display of treasury stock in the financial statements. The auditor should have some familiarity with the state laws concerning the accounting for and presentation of treasury stock and consult with legal counsel when necessary.

Some corporations have sold substantial blocks of treasury stock prior to the close of the year under an agreement to repurchase the

stock at the same price shortly after the beginning of the new period. This procedure may be simply a form of window dressing or the agreement may be so worded to protect the purchaser from loss on resale of the stock. In any event, commitments to repurchase a company's stock or to protect the purchaser from the effects of a falling market should be revealed on the balance sheet.

Surplus.—The auditor is faced with an important problem in reconciling the legal concept of capital with the economic and accounting concept of contributed or invested capital. The introduction of surplus arising out of the proceeds of stock issues has confused the distinction between capital contributed by stockholders and earnings or profits retained in the business. The balance sheet presentation of capital should maintain the distinction between paid-in capital and earned surplus. This can be accomplished by showing both legal capital and paid-in surplus and extending the total to indicate contributed capital in one amount. It can be shown by entering as capital stock the full amount contributed by stockholders with parenthetical notation of the amount of legal capital. Generally, surplus on the balance sheet is classified as to source and the descriptive caption attempts to indicate whether the surplus arose from stockholder contributions, from appraisals, or from other sources. Good accounting practice requires that earned surplus be stated separately from other surplus and that such other surplus be described so as to give reasonably adequate information as to its source. The more usual classifications of surplus are earned surplus (or deficit), paid-in surplus, and surplus arising from revaluation. Each should be shown separately on the balance sheet.

Corporations with long and complex financial histories may find it difficult to segregate surplus as to its source and therefore indicate surplus in one amount. If surplus is indicated in one amount, it is desirable to disclose the circumstances of its origin in a note to the financial statements. Usually, however, it is possible to distinguish between undistributed profits (earned surplus) and surplus arising from other sources.

When part of the capital contributed by stockholders is not stated as capital stock or stated capital, it should be stated separately from earned surplus, surplus arising from unrealized appreciation, and other kinds of surplus. The credit arising from increasing the book amount of assets as the result of an independent appraisal or for other reasons may be described as "surplus arising from revaluation" or by some similar caption.

The subject of quasi-reorganizations with a resulting dating of earned surplus has been previously discussed. An additional factor to be considered is the length of time during which the earned surplus should be dated after a quasi-reorganization. There is no settled opinion among accountants generally whether the dating of surplus should be continued indefinitely or limited to a certain period.

Regulation S-X of the Securities and Exchange Commission for statements filed with it under the Securities Act of 1933 and the Securities Exchange Act of 1934, provide, for commercial and industrial companies:

> *Surplus*—(a) Show in the balance sheet the division of this item into (1) paid-in surplus; (2) surplus arising from revaluation of assets; (3) other capital surplus; and (4) earned surplus. However, if, in the accounts, separate balances for these are not shown at the beginning of the period of report, i.e., if the company has not, up to the beginning of the period of report, differentiated in its accounting for surplus as indicated above, then the unsegregated items may be stated in one amount. If the above segregation of surplus is not made, the account titles used shall be such as will indicate the general types of surplus included therein. If undistributed earnings of subsidiaries are included, state the amount thereof parenthetically, or otherwise. However, in a consolidated statement, the preceding sentence shall have reference only to the undistributed earnings of subsidiaries not consolidated in such statement.

Balance sheets may contain an analysis of surplus showing a summary of the changes during the year. If the changes are too numerous to be clearly explained on the face of the balance sheet, the details may be presented as a continuation of the statement of income or in a supplemental statement of surplus.

Restrictions on surplus should be indicated in a footnote or in a parenthetical notation. Restrictions imposed by bond indentures, state laws, or charter provisions are examples of those which should be disclosed. Frequently bond indentures include restrictions not only on the payment of dividends but also on the use of assets for the purchase of capital stock.

Donated surplus should be separately shown on the balance sheet. Credits arising from forfeited capital stock subscriptions should also be shown in an appropriately titled surplus account.

Surplus Allocations.—Terms of bond indentures, preferred stock agreements, or other contractual obligations often make man-

datory the segregation from surplus of amounts otherwise available for dividends. Occasionally, amounts are voluntarily segregated from free surplus by action of a corporation's board of directors. Whether the segregation is voluntary or involuntary, it results in appropriated or allocated surplus. The mere allocation of surplus does not alter its essential character. It remains surplus, but subject to such restrictions as may be imposed by the conditions which dictated its segregation. If the auditor's examination discloses that there has been or should have been an allocation of surplus, before he submits his opinion on the balance sheet he should ascertain that the allocation has been properly authorized and that the appropriation is adequately described in the balance sheet. Adequate description of any material amount ordinarily includes recitation of the purpose of the appropriation.

It is entirely proper to characterize the allocation as a reserve but the term "reserve" does not, by itself, constitute an adequate description since it does not indicate the purpose of the appropriation. The inclusion of the term "reserve" in the description should serve notice on readers of the balance sheet that the amount to which it applies is appropriated surplus, but the frequent misuse of the word makes it inadvisable for the auditor to presume that its implications will be clear to the reader of the statement.

Those reserves which are genuine surplus appropriations should be designated as reserves on the balance sheet with accompanying qualifications adequate to reveal their purpose. There may be many of these surplus reserves and generally they precede earned surplus on the balance sheet. If, however, a surplus reserve is appropriated from paid-in surplus, it should precede paid-in surplus.

Capital of Business Partnerships.—In a firm of two or three partners, the balance sheet may show a summary of the changes in each partner's capital since the date of the previous statement or a summary of the changes in the combined capital, presenting in a supplementary statement in detail the changes within the period in the capital of each partner, including contributions, withdrawals, share of current profits or losses, interest credits or charges, and salary allowances.

Capital of Nonbusiness Organizations.—Capital of nonbusiness organizations is frequently stated on the balance sheet under headings sufficiently descriptive to indicate general restrictions of their use. Such capital may be stated as current funds, plant funds, or endowment funds, or in other classifications as indicated by restric-

tions on the accounts. Capital changes during the period should be analyzed, either on the balance sheet or in a separate summary. The balance at the beginning of the period, changes during the period, the sources of additions, the nature of distributions, and the allocation of the balance at the date of the financial statements should all be shown.

DIVIDENDS

ACCOUNTING PRINCIPLES

Introduction.—A dividend has been defined as a pro rata distribution to the stockholders of a corporation. Dividends may be classified as to the medium of payment (cash, property, or stock) or the source (earned surplus or paid-in capital). Usually the term "dividend" without other qualification indicates a pro rata distribution in cash, paid out of earned surplus to all stockholders of a given class.

The board of directors of a corporation decides when and in what amounts dividends shall be paid. It should take into consideration the financial position and earnings of the company, the general business outlook, and future plans of the company. Often it is advisable to have counsel pass on the legality of proposed dividend actions.

Dividends are declared by a formal vote of the board of directors indicating the amount per share to be paid, the payment date, and the record date; the declaration should be recorded in the minutes of the directors' meetings. Only those persons owning the stock as of the record date are entitled to dividends declared.

When a cash dividend or its equivalent has been declared and public notice of it has been given to the stockholders, the dividend is a legal obligation and it is the general opinion that when the declaration is legal, it may not be rescinded without the consent of all the stockholders.

Classification of Dividends as to Medium of Payment.—Dividends may be paid in cash, in other assets, in capital stock of the distributing corporation, or in scrip. Payment of dividends in cash is by far the most usual and the accounting for such dividends presents few problems.

Stock dividends are paid in capital stock of the corporation making the distribution. A dividend on one class of stock is usually paid in the same class of stock but is sometimes paid in stock of another class. Occasionally, dividends are declared payable in property, such

as marketable securities of other corporations. Some distilling companies have paid dividends from finished stock inventory. Usually the difficulty of apportioning property, other than securities, among many stockholders owning various proportions of the outstanding stock discourages the payment of dividends in property.

When a corporation otherwise in a position to pay dividends lacks cash or other assets suitable for distribution, it may resort to the payment of dividends in dividend scrip. Dividend scrip is usually an issue of short-term interest bearing notes payable to stockholders in cash at a future date.

Sources of Dividends.—From a common-sense business standpoint, dividends should be paid to stockholders only from accumulated earnings. Dividends have been charged to paid-in surplus or some classification of surplus other than earned surplus without a clear statement of the source of the dividend and without violating state regulations. It reflects no great credit to lawmakers that this can be done, as the incongruity of contributing to the capital of a corporation and then receiving part of it back in the guise of ordinary dividends should be sufficiently evident to encourage making the practice legally impossible. Disregarding the legality of such dividends, however, directors may be violating their trust if they declare dividends out of capital without making it clear to the stockholders that the dividends are not distributions of earned income. If more states had legislation which, like the Ohio General Corporation Act (Section 8623-38), provides that when dividends are paid out of capital "the shareholders receiving such dividends shall be notified as to its source," the authors believe that few dividends would be paid from capital surplus. It takes a courageous board of directors to acknowledge publicly that it is paying ordinary dividends out of capital.

When paid-in surplus has been created from payments by stockholders in the form of premiums or assessments, it may be desirable to capitalize it formally through the declaration of a stock dividend. Such dividends represent nothing more than a formal capitalization of what has been contributed as capital by the stockholders.

Securities and Exchange Commission Rule U-46 under the Public Utility Holding Company Act of 1935, provides, in part as follows:

> No registered holding company or subsidiary thereof shall declare or pay any dividend on any security of such company out of capital or unearned surplus, except pursuant to a declaration notifying the Commission of the proposed transaction. . . . .

The Commission has approved dividend payments on preferred stocks out of paid-in surplus when there was no earned surplus or when earned surplus was less than the amount of the proposed dividend. One of the Commission's conditions in approving these distributions was that the amounts be restored to paid-in surplus from the first available earnings after specified dates. The Commission has quoted circumstances supporting its findings, such as that after payment of the proposed dividends a substantial protective common equity would remain behind the preferred stock, indication of current earnings sufficient to maintain regular dividend payments and in time to replenish paid-in surplus, and sufficient cash for the dividend payment.

Section 19 of the Investment Company Act of 1940, provides:

> It shall be unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than—
>
> (1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or
>
> (2) such company's net income so determined for the current or preceding fiscal year;
>
> unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors.

Availability of Surplus of Subsidiaries for Distribution.— Companies often purchase stocks of subsidiaries which have substantial surplus accounts. Surplus earned by a subsidiary prior to acquisition should be excluded from consolidated earned surplus and dividends paid to the parent company out of surplus accumulated by the subsidiary prior to its acquisition should be credited to the investment account on the parent company's books.

While subsidiaries may declare dividends from their surplus accumulated prior to acquisition, the parent company should not treat them as income, but as returns of capital invested in the subsidiary. When dividends are paid by the parent company from this source, the fact should be disclosed. The Uniform System of Accounts for Public Utility Holding Companies, prescribed by the Securities and Exchange Commission, recognizes this important principle, and states:

> Dividends from earnings of the paying company prior to acquisition by the accounting company of the stock in respect of which the dividend was paid shall not be taken up as income or surplus but shall be treated as a distribution of capital.

There may be other limitations on the payment of dividends by subsidiaries to the parent company. Provisions of bond indentures and stock agreements of the subsidiary companies may restrict the payment of dividends to the parent from the earned surpluses of these companies.

Dividends Paid in Property Other Than Cash.—There are two viewpoints in respect of the amount to be charged to surplus of the disbursing corporation upon payment of a dividend in property. Surplus may be charged with the cost of the property to the disbursing corporation or with the market value of the property at the date the dividend is declared, any difference between market value and cost being reflected as a charge or credit to income or surplus of the period. Problems arise under both applications and it is not always possible to ascertain a fair market value. Income tax considerations may have an important bearing on the accounting treatment selected.

Dividends in property should not be booked at cost if the value of the property has declined appreciably below cost, because by this treatment the loss is not reflected in the income statement. If dividends are paid in property having a readily determinable market value appreciably in excess of the amount at which the property is carried on the books and these dividends are charged to surplus at book amount, the amount of this difference should be clearly indicated in the current financial statements.

Full details of dividends in property should be given to stockholders indicating both market value and cost. This is particularly important when there is more than one class of stock and the property is being distributed to one class only. An undisclosed transfer of appreciation to one class of stock may be objected to by holders of other classes of stock. Preferred stock at a fixed dividend rate should not be allowed to profit by receiving dividends in property the value of which exceeds the fixed rate.

Stock Dividends and Stock Split-ups.—In some respects, there is a similarity between a stock dividend paid in the same class of stock and a stock split-up. The term "stock dividend," as defined in Accounting Research Bulletin No. 11, issued in September, 1941, "refers to the issuance, by a corporation, of additional shares of any class of its own capital stock to the presently existing stockholders

of the same or a different class of shares without consideration moving from such stockholders to the corporation. Such a stock issue involves an increase in the legal capital of the corporation." This bulletin defines a split-up as a ". . . . division of issued shares into a greater number of shares of the same class without change in the aggregate amount of legal capital." A stock dividend involves a charge to surplus, although the capitalization of an amount of surplus to comply with statutory requirements is not sufficient to classify a split-up as a stock dividend.

When earned surplus is converted to capital stock through declaration of a stock dividend, the effect is to recognize as legal capital amounts theretofore recorded as earned surplus. Bulletin No. 11 made certain recommendations with respect to the amount to be transferred from earned surplus to capital stock and paid-in surplus, which is referred to in the Bulletin as capital-surplus, in the case of an "ordinary" stock dividend. The authors do not believe that Bulletin No. 11 was intended to apply to "extraordinary" stock dividends, such as one new share for each old share, or even one-quarter of one new share for each old share. These "extraordinary" stock dividends are more in the nature of "split-ups."

To summarize Bulletin No. 11, the amount to be charged to earned surplus per share of stock issued as a dividend should be the book amount of stated capital and paid-in surplus per share before issuance of the dividend; when this amount is substantially less than the market value per share, the amount capitalized should be adjusted to bear a reasonable relationship to the market value.

Dividends Payable in Cash or Stock at Option of Stockholder.—A dividend payable in stock or cash at the option of the stockholder may not be a true stock dividend for it may not be a pro rata distribution of shares. After a stock dividend the percentage of the total shares held by each receiving shareholder in the class of shares being paid remains the same as before the distribution except when the dividend is paid in stock of a different class. When there is an optional stock or cash dividend, the proportions may be changed if cash is taken by certain shareholders.

In such a distribution, the amount of earned surplus to be capitalized should be not less than the amount per share of the optional cash dividend. A corporation which gives the stockholder the choice of a cash dividend or a stock dividend usually makes the offer in such a way that the choice of stock appears more advantageous to the recipient.

Constructive Dividends.—Constructive dividends are distributions to stockholders in the ratio of their shareholdings without formal action of the board of directors in declaring and paying a dividend. The constructive dividend has received attention mainly as a result of income tax regulations. In a closely held corporation, if salaries or bonuses are paid to officers who comprise all of the stockholders of the company and if such salaries or bonuses are not based upon the values of their services but bear some relation to their stockholdings, under federal tax regulations all or part of such payments are treated for tax purposes as distributions of profits and not as business expenses.

Liquidating Dividends.—Dividends paid out of contributed capital are known as liquidating dividends. Such dividends may be paid by a going concern in accordance with statutory provisions or they may be paid with the express intent of reducing the capital of the corporation, with a view either to its dissolution or to its continuance without disturbing its earned surplus.

Dividends Paid from Amounts Specifically Included in the Price of the Stock.—Occasionally, specific amounts equal to accumulated dividends per share are added to or included in the prices at which shares of capital stock are sold by the issuer with the intention that these amounts are to be returned to the stockholders as part of the first dividends to be received by them. Certain types of investment trusts may be required by their certificates of incorporation to segregate a portion of the amounts received from the sale of their capital stock to equalize the per share amount of undistributed realized or unrealized net income. This procedure is designed and executed to maintain, for the benefit of the existing stockholders, their per share amount of distributable income which might otherwise be reduced upon the issuance of new shares. A somewhat similar situation exists when a corporation issues preferred stock at a price plus accrued dividends, when the first dividend is paid for a period beginning prior to the date of issuance of the stock.

There appears to be no reasonable or practical basis for objection to the procedures described above, even though the amounts charged for accumulated dividends technically may be considered premiums. With the exception of common stock issued by certain types of investment trusts, such procedure is usually confined to issues of cumulative preferred stock.

Dividends of Wasting-Asset Concerns Paid Out of Capital.—The statutes of some states permit the determination of distrib-

utable income of companies engaged in the metal, timber, oil, and other wasting-asset industries without a deduction for depletion. Accordingly, in those states, the entire realization from capital invested in these wasting assets may be legally paid out in dividends. From an accounting standpoint, if this dividend policy is followed, it is desirable that financial statements disclose the amount of capital distributed as dividends in the current year as well as the accumulation of these distributions to date. Some companies with wasting assets, however, omit depletion allowances in financial statements and further, in paying dividends make no attempt to distinguish between distributions of earnings and distributions of capital. These procedures, which the authors do not approve, are defended on the following bases:

1. It is impossible to obtain information sufficiently accurate for use as a basis upon which to calculate depletion.
2. Investors in an extractive concern expect the management to exhaust such assets but they do not expect the management to reinvest the realization of original capital. They expect such realization to be distributed to them and on this basis an allowance for depletion becomes of no importance.

Other companies follow what the authors believe to be good accounting practice and provide for depletion of wasting assets in computing distributable income. Those companies argue in support of their position as follows:

1. While it is recognized that it is not always possible to make exact provision for current depletion, nevertheless the determination of depletion allowances based on the best available current information is preferable to no depletion at all.
2. Most of the major wasting-asset companies of the United States do not distribute to their shareholders all of their income realized in cash but retain part of it for the purpose of financing, exploring, investigating, and acquiring new properties. Investors in such major companies are quite content to allow managements to invest capital realizations for them in new properties.
3. While it is probably true that investors in closely-held wasting-asset companies are not greatly concerned whether or not depletion allowances are deducted in arriving at distributable income, the ordinary investor not closely associated with management may be confused and misled by financial state-

ments in which no consideration is given to depletion and in which no indication is given of the amount of capital returned as dividends.

4. The statutes of the various states and court decisions which legally permit distribution of capital realizations without indication of their character should not necessarily be determining factors in the decision as to what constitutes good accounting practice.

So far as the nonferrous metal companies are concerned, there seems to be a rather even division of opinion as to the propriety of preparing financial statements which do not recognize depletion, although the subject is currently receiving attention by authoritative accounting bodies. Tax regulations require that when depletion is omitted and dividends are paid from capital due notice must be given to stockholders. Regardless of what is legally permitted by state laws and under court decisions, the auditor should uphold the principle that paid-in capital should not be impaired by the repayment to stockholders of any of their contributed capital in the guise of ordinary dividends.

INTERNAL CONTROL

Many large companies employ a dividend paying agent to handle the payment of dividends to stockholders. When such an agent is used, the requirements of internal control procedures within the company over the payment of dividends are appreciably reduced.

The dividend should be properly declared and recorded in the minutes of the board of directors; notification to the agent should be signed by a designated company officer; and a check transferring the amount of the total dividend on the outstanding stock to the agent should be signed by the treasurer, and possibly co-signed by another responsible official. The notification should include all pertinent information as to the payment and record dates, and the authorized recipients. Dividend checks should be imprinted with the name of the corporation, signed by the paying agent, and mailed to reach the stockholders on the date dividends are declared payable.

When a company acts as its own dividend disbursing agent, the need for internal control is greater. The dividend should be properly declared as previously noted. A separate bank account should be maintained for dividends and all activity in the account should be subject to the authorization of the treasurer or some other designated official. Controls over disbursements from the dividend account

should include those relating to bank accounts in general, discussed in the chapter on cash.

It is important in controlling dividend payments to make sure that the total dividends paid do not exceed the amount determined by multiplying the number of shares of outstanding stock (not including treasury stock) by the dividend rate. This may be accomplished by transferring the total dividend to the special dividend account and checking the total of the individual dividend checks to the amount transferred before sending them out.

The control of unclaimed dividend checks is not limited to physical control in a vault or other safekeeping device, but includes control of the accounting record of them. After a short period, unclaimed dividends may be transferred to a separate account so that the dividend payable account will reflect only current dividend transactions. Unclaimed dividends should not be left on the books indefinitely, but, if the laws of the state permit, on advice of counsel they should be returned to surplus after an appropriate period has elapsed.

If there is an internal audit staff, certain of the audit procedures described in the following section on auditing of dividends should be followed. If feasible, canceled dividend checks may be returned to the audit department for examination and checking to the stockholder records as an additional control measure.

AUDITING PROCEDURES

The auditor's procedures in the examination of the dividend accounts should be designed to assure him that all declarations are authorized by the board of directors, that authorized amounts are paid on the designated dates to recorded stockholders and that all distributions, cash or otherwise, are treated in the accounts in accordance with generally accepted accounting principles. The auditor should have a sufficient familiarity with the type of problems which may arise with the declaration, recording, and payment of dividends to realize when advice of counsel should be obtained. One of the duties of the auditor is to see that the intentions of the board as indicated in the resolutions authorizing the dividends are properly reflected in the accounts.

As to authorization, the minutes of meetings of the board of directors should contain the formal declarations. In the absence of a formal declaration of dividends, distributions to stockholders should be examined and if the evidence indicates a dividend in fact, the auditor should recommend that the distribution be ratified at the next meeting of the board.

When the total amount to be paid in dividends is transferred to a disbursing agent, the auditor should substantiate the computation of the total and the transfer of funds. If the dividends are paid by the corporation, rather than by a disbursing agent, the auditor should ascertain that the aggregate of the amounts paid is correct; that is, that for each dividend the number of shares outstanding multiplied by the dividend rate specified in the minutes of the board meeting equals the total amount paid. In addition, he may test, or check all of, the individual amounts of dividends, per the list of dividends paid to stockholders, by multiplying the shares owned of record by such stockholder by the dividend rate. When pro rata dividends are paid on uncompleted installment subscription contracts, the auditor should compare the amounts paid with the amounts received by the corporation on the subscriptions and check the propriety of the ratios used.

If the funds have been placed in a special bank account, the auditor may reconcile the account and ascertain that it is being used for no other payments. Sometimes there is carried in such an account a minimum balance which may constitute a part of the general cash.

The unclaimed dividend account should be examined and the accounting treatment of unclaimed dividends after expiration of the legal holding period should be reviewed.

The auditor should familiarize himself with the dividend laws of the state in which the client is incorporated and with any of the corporation's agreements which may contain provisions relating to dividend policies. When a company legally pays dividends and charges them to paid-in surplus, the accountant can do no more than point out the objections of this course to the directors and require that full disclosure be made in the financial statements.

When stock dividends are paid, the auditor should ascertain that the accounting treatment has been proper and that the statements reveal the amount of surplus capitalized, its source, and the number of shares issued.

The auditor should read preferred stock agreements. While he is entitled to a lay opinion as to whether the provisions have been properly complied with, the interpretation of these agreements is primarily a legal matter and questions of interpretation should be referred to counsel.

Holders of noncumulative preferred stocks ordinarily have no claim to dividends in a year when the amount of the dividends has not been earned, except possibly when dividends earned in a prior year have been improperly withheld. Dividends paid on common

stocks may have encroached upon the rights of holders of noncumulative preferred stocks. In such event the auditor should remind his client of the facts and the terms of the preferred stock issue and suggest that counsel be consulted with respect to the possibility of a liability to holders of noncumulative preferred stock.

When the price of stock sold has included accumulated dividends, the auditor should determine that the accumulated dividends have been correctly computed and that the accounting treatment has been proper.

When a stock dividend on common stock is payable in preferred shares, the auditor should ascertain, usually by inquiry of counsel, that the corporation has complied with requirements relating to the consent of the holders of senior shares and with the various formalities for the issuance of new or additional preferred shares. He should ascertain as well that the capitalization of earned surplus is proper.

If a dividend has been paid on preferred stock in common stock the auditor should satisfy himself, usually by inquiry of counsel, that statutory requirements have been complied with and that the proper amount of earned surplus has been capitalized. When such a dividend is paid, due consideration to the relative interests of the different classes of stockholders requires that little discretion be allowed directors in determining the amount of earned surplus to be capitalized, especially when the preferred stock upon which the dividend is paid is cumulative or participating.

The auditor should ascertain that proper procedures have been followed not only in accounting for regular distributions, but also in accounting for stock split-ups, dividends payable in scrip, and dividends payable in assets other than cash. In the distribution of a stock dividend or in a stock split-up, it is also important to ascertain that the capital stock authorization is not exceeded.

Coordination of Examination with That of Related Accounts.—The examination of dividend accounts normally will be made in conjunction with that of capital stock and surplus accounts.

Time of Examination.—Preliminary analyses of dividend accounts may be made at a date prior to the balance sheet date and later brought up to the year end.

STATEMENT PRESENTATION

Dividends paid are usually shown in the analysis of surplus, whether it be in the surplus section of the balance sheet, a continua-

tion of the income statement, or a separate surplus statement. It is customary to indicate the total dividend for each class of stock and whether the dividends were paid in whole or in part out of surplus other than earned. Frequently the dividend rate per share is indicated.

Since there are many variations in the requirements of corporate agreements and state legislation, a client may legally declare dividends out of a source other than earnings which, because of the absence of accompanying explanatory comment, may be misinterpreted by uninformed stockholders as distributions of earnings. The auditor should suggest adequate disclosure of the circumstances and source of such dividends, failing which he should state an exception in his report.

When a liquidating dividend has been declared and all the legal steps taken requisite to the reduction of the stock, but the payments to stockholders have not been made, the balance sheet should show the outstanding stock at its reduced amount and the liquidating dividend as a current liability, adequately described.

When dividends are paid in stock or in property, the value of which may be a matter of opinion or may have been determined arbitrarily, it is good procedure to indicate in the financial statements the basis used by the board of directors in determining the dollar value of the property distributed to stockholders.

CHAPTER 20

INCOME, COSTS, AND EXPENSES

The form and purpose of the statement of income are discussed in Chapter 7, where it is emphasized that the statement is by its nature historical and not prophetic, although the objective of revealing as far as possible the earning power of the enterprise should not be lost sight of; informative classification, description, and annotation of both the balance sheet and the statement of income are helpful in attaining this objective.

The income statement has been and to a lesser extent still is influenced by accounting practices followed in preparing the balance sheet, and this fact has a profound effect upon the accounting principles, the features of internal control, and the auditing procedures involved. Whatever principles of valuation are applied to current assets, whatever policies are adopted in the capitalization and depreciation of plant, and whatever the methods of recognition of liabilities, all find their way to income or, to a limited degree, directly to surplus. Appreciation of this relationship has more and more led accountants to apply accounting principles so as to result in the fairest determination of income, with only secondary consideration of the balance sheet result, and thus the position of relative importance may be reversed. Internal controls over assets and liabilities are frequently indistinguishable from controls over the related income, costs, and expenses. The close relationship between the balance sheet and the income statement has in the past led many accountants to describe their customary examination of financial statements as a balance sheet examination simply because so many of the auditing procedures, upon which they based their opinion of the income statement, were also undertaken for balance sheet purposes or were undertaken concurrently with the examination of the balance sheet. While greater emphasis has been given to auditing procedures of income in recent years, many of the basic auditing procedures have remained unchanged.

ACCOUNTING PRINCIPLES

In General.—The income statement should reflect all transactions during its period which result in realized profit or loss, excepting

such extraordinary items as will materially distort current income as discussed in Chapter 7, and should exclude distributions of income to stockholders and capital transactions. The income statement should also reflect corrections of estimates of prior years' income unless, again, such corrections result in material distortion.

The doctrine of conservatism as applied to the income statement recognizes income only after realization in terms of cash or its substantial equivalent and provides not only for realized but also for probable costs, expenses, and losses. Sound judgment is required in the application of this doctrine, as it is susceptible of abuse.

On the other hand, expenditures which result in clear benefits to future periods or which result in the acquisition of tangible or intangible assets, may or should be deferred or carried as assets; the applicable accounting principles are set forth in the various chapters on balance sheet accounts. Conservatism in the deferment or capitalization of expenditures properly results in charging off currently the borderline items.

Sales.—Sales represent the consideration received or receivable from the disposition of inventories to customers in the ordinary course of business and usually involve physical delivery and passage of title. Sales of service or of allied commodities may be included in sales or in operating revenues; casual sales of property other than inventories should ordinarily not be included in sales and the profit or loss thereon should be accounted for as other income or other deductions.

Returns, Allowances, and Discounts.—Returns represent cancellations of previous sales and usually involve return of the merchandise. Allowances consist of credits to customers to adjust for errors in pricing invoices, shipments of the wrong merchandise, defects in quality, shortages in shipments and the like. Disputes may often exist as to the correct amounts of credit to be issued to the customer for returns and allowances. As set forth in Chapter 11, selling prices are frequently quoted on a gross basis and discounts are allowed which fall into three classes: quantity discounts (which vary as the name implies with the quantities purchased), trade discounts (which depend upon the classification of the customer as manufacturer, wholesaler, or retailer) and cash discounts (2 per cent or less). The absorption of freight or taxes by a seller is often considered to be an allowance or a discount. Accounts for sales are customarily maintained to show the gross selling price and the various reductions for returns, allowances, or discounts; cash discounts

allowed may be accounted for as other charges although the trend seems to be towards their treatment as a reduction of the gross selling price.

It is good practice to provide in the accounts for any material amount of returns, allowances, or discounts which can reasonably be expected to result from past sales; the amount of the provision can usually be determined with reasonable accuracy in the light of past experience.

Cash Sales.—Receipt of cash in return for merchandise sold ordinarily minimizes the accounting questions involved in the recognition of income; however, cash received in advance of the delivery of merchandise ordinarily should be credited to a liability or deferred income account and taken into income upon delivery of merchandise or at whatever point performance is recognized as fulfilling the sale.

Consignment Sales.—Merchandise shipped to others on consignment or any similar basis should not be recorded as a sale; upon disposition to a customer the consignee should record his commission and the consignor the sale and related commission expense.

C.O.D. Sales.—As discussed in Chapter 11, while title to shipments, under collect-on-delivery terms, remains in the seller until delivery to and collection from the purchaser, it is proper either to recognize such shipments as sales or to record the sale after delivery and collection. If a sale is recorded when the merchandise is shipped, the important consideration is whether the receivable is good. Department stores and other retail organizations usually account for C.O.D. shipments as sales since this method facilitates merchandise control under a perpetual inventory system and returns can be accounted for through a reserve.

Installment Sales.—Automobiles and the larger household appliances have been sold on the installment basis for some years; more recently the practice has been extended by some retailers to include practically the entire list of consumer goods. Installment financing may range from plans whereby the seller carries the installment paper himself, to plans under which a bank or finance company takes over the receivables without recourse, relieving the seller of further financial risk. Installment sales commonly involve the retention of protective title under a conditional sale, chattel mortgage, or some similar arrangement depending upon the laws of the state in which the merchandise is sold. Additional charges to the purchaser may include interest, service fees, and insurance.

Installment sales may be accounted for on the same basis as other sales or on the installment method under which gross profit is considered to have been realized as collections are made. This latter method is more conservative and may be preferable when the down payment is small and the collection risk is substantial. The Treasury permits the installment method for tax purposes under certain circumstances and the adoption of the method may substantially defer the payment of income taxes. When the collection risk is considered to be extreme, it is good practice to defer the recognition of profit until the entire cost has been recovered.

Under the installment method, the portion of the charge for financing and servicing is deferred and taken up as income over the period of collection.

Long-Term Contracts.—As discussed in Chapter 11, it may be permissible and desirable for a contractor working on contracts which require some time to complete, to account for sales on the basis of progress billings, usually according to the terms of the contract. On the other hand, some contracts may involve such risks or the determination of profit may be so difficult that it may be preferable to defer the recognition of profit and the recording of the sale until completion of the work.

Export Sales.—When shipments are made to customers in foreign countries on some basis other than cash in advance, the collection problem may be complicated by shortages of United States dollars in the foreign countries. Frequently title to such shipments may remain in the seller, under an arrangement such as a sight draft with bill of lading attached, in which event it may be desirable to account for such shipments as sales only when collection is made.

Intracompany and Intercompany Sales.—It is frequently desirable to record the transfer of semifinished and finished products from one department and plant to another as sales at current market prices. In some businesses there may be several distinct stages in the manufacturing process between raw materials and finished stock. Competing businesses may have one or more of these identical stages and what is a finished product for one company may be a raw material for another. For instance, one steel company may mine ore and manufacture pig iron whereas another may purchase pig iron as a raw material. Thus a primary purpose of accounting for transfers of products within a company as sales is to show the departmental results on an independent basis. These sales should be segregated in

the accounts to facilitate their elimination in the income statement and the elimination of the unrealized profit from inventories.

Proper regard for maintenance of separate corporate entities usually requires that sales between affiliated companies be recorded at current market prices, and the considerations which apply to intracompany sales apply to the recording and elimination of intercompany sales and of intercompany profits from inventories, in the preparation of consolidated income statements.

By-Product Sales.—Some types of manufacturing processes yield a primary product and a by-product. If the by-product is of minor importance, the proceeds of its sale are usually applied as a reduction of the manufacturing cost of the primary product. If the by-product is of major importance, sales may be treated similarly to those of the primary product.

Operating Revenues.—When one of the primary purposes of the enterprise is the furnishing of service or the sale of a commodity which is closely allied with the furnishing of service, the proceeds therefrom are generally termed operating revenues. Transportation by steam or electric railroad, by bus, streetcar, ferry, boat, or over a toll bridge, and the furnishing of electric power, water, gas, steam, telephone, or telegraph service are examples of services or commodities furnished by enterprises which are commonly defined by law as public utilities, the proceeds from which are classified as operating revenues under uniform systems of accounts prescribed by regulatory bodies. Certain companies, other than public utilities, may be in the primary business of renting equipment or real estate, or of selling service, entertainment, and the like, the proceeds from which are more commonly described as an operating revenue rather than as a sale.

Generally, operating revenues are taken into income when the commodity has been furnished or in the period in which the service is rendered. Operating revenues are usually received in small amounts at frequent intervals and do not usually present problems in determining the period of realization. When cash is received in advance, as from ticket sales, it may be permissible to record income at the time of receipt, particularly if receipts are regular and recurring, or it may be preferable to defer receipts until the service is rendered or the commodity delivered.

Other Income.—Other income includes income from sources outside the normal operations of the enterprise. Thus dividends are

usually classified as other income except when, as in an investment company, they are one of the principal sources of income.

Cash Discounts on Purchases.—As stated previously, cash discounts on purchases are preferably considered a reduction of invoice price or cost of sales although frequently they are treated as other income.

Dividends.—Cash dividends, with the exceptions discussed below, constitute income and are usually recognized as such after the ex-dividend date. Dividends are infrequently paid in property but when they are they may also represent income in the amount of the property's fair market value.

Some of the recognized exceptions to the treatment of dividends as income are as follows:

1. Dividends paid from surplus of a subsidiary earned prior to acquisition of control by the parent are not income to the parent but should be credited to the parent's investment in the subsidiary. This treatment may be extended to dividends from companies which are not subsidiaries, particularly when a large dividend is clearly earned prior to acquisition of the investment.
2. Dividends on a company's stock held in its treasury are not income and they should be treated as a reduction of dividends paid.
3. Dividends in stock of the paying company ordinarily should not be treated as income by the recipient. Accounting Research Bulletin No. 11, issued in September, 1941, in indicating that exceptions to the rule may be justified under certain conditions states that "it is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, . . ."
4. Dividends in liquidation or from surplus other than earned surplus are not income except in rare cases.

Treatment of dividends under laws of the various states governing probate accounting and under federal and state income tax laws may vary greatly from that indicated by generally accepted accounting principles.

Interest.—Interest from solvent debtors which is being paid regularly is usually accrued currently in the accounts. When interest

is not being paid regularly, or when there is some doubt as to its payment, it should not be accrued. When investments include substantial amounts of bonds which were purchased at premiums over or discounts from their face amounts, it is frequently the practice to amortize the premiums over the period to the earliest call date or maturity; it is less frequently the practice to take up as periodic income a portion of the discount. Discount on speculative bonds should not be amortized when the discount is large and its eventual realization uncertain.

Rents.—Rents are usually based upon a written agreement and may be received for the use of real or personal property. They should be recorded as income as they accrue unless the lessor is on a cash basis, in which event they should be recorded as income when received. Rents received in advance should usually be deferred for inclusion in income in the appropriate accounting period.

Royalties.—Royalties are usually based on agreements for the use by others of patents, copyrights, or secret processes and the like or for the extraction of minerals. Royalties should be taken into income in the period in which earned or reported.

Profits on Sales of Securities and Fixed Assets.—When the entire holdings of one issue of securities are sold there is no problem of apportioning the total cost to any part; however, large holders of securities may sell only a portion of their holdings of one issue. In the accounts, the first-in, first-out or average cost bases are preferable to specific identification since they offer less possibility of increasing or decreasing reported profits arbitrarily. For federal income tax purposes the rule is that when there has been no specific identification of securities sold, the first-in, first-out method of costing sales applies.

Accounting for profits on sales of fixed assets is largely affected by the related depreciation methods. If the composite rate method is used, no profit or loss is recognized unless it involves the disposition of a whole group or a major unit. Profits on the sale of fixed assets should not be recorded until title has passed or until there is a clear unequivocal right to receive the sales price.

Cost of Sales.—In general, cost of sales includes all direct and factory indirect costs of purchase and production of goods sold. The cost of sales of many manufacturing companies represents cost of production adjusted by opening and closing inventories; cost of sales usually includes such items as write-down of inventories to market,

royalties paid for the right to manufacture or for use of patented equipment, amortization of preproduction or tooling costs, services or other costs under product warranties, sales of by-products or scrap. The term "cost of sales" does not have any well recognized, precise meaning, and as indicated, more often than not the item "cost of sales" on a statement of income includes items other than the cost of goods sold.

Operating Expenses.—Operating expenses represent the costs and expenses applicable to the production of operating revenues. In a public utility they consist of the direct production and distribution costs of the commodity sold or service furnished, such indirect costs as depreciation, maintenance and repairs, property and other operating taxes, and cost of service departments, and income taxes and expenses classified in a manufacturing company as selling, general, and administrative.

Selling, General, and Administrative Expenses.—This group of expenses represents costs of selling the product and administering the enterprise. Selling expenses include salesmen's salaries, commissions and expenses, advertising, overhead of the sales department, entertainment of customers, and the like. General and administrative expenses include salaries and expenses of the general executives, of the general accounting and credit departments, such corporate expenses as transfer agents' fees and expenses of reports to stockholders, certain taxes, and legal and auditing fees. Any other expenses not related to production and not outside the usual activities of the enterprise are usually included in this category.

Depreciation and Amortization; Maintenance and Repairs.—Chapter 13 is devoted to the various methods of currently recognizing in the accounts the amortization of plant and property over its useful life as well as the methods of accounting for related expenses of maintenance and repairs. Chapter 12 deals with the question of capitalizing or charging off expenditures related to plant and property. Chapter 14 describes the methods of amortizing intangible assets and discusses the question of capitalizing or charging off expenditures related thereto.

Experimental and Development Expenses.—Although experimentation and development expenses are usually related not to current but to future production, it is usually better practice to charge off these expenses as incurred although there is authority for their deferment in certain circumstances. In many industries constant expendi-

tures of this sort are characteristic and necessary if products are to be made better and cheaper. There are two considerations that permit deferment of these expenditures: that future periods, rather than the current period, will receive whatever benefits arise from the amounts deferred and that there appears to be an element of continuing value. The considerations against deferment, and in the authors' opinion they usually outweigh those in favor of it, are (1) that the future benefits may be intangible and impossible to measure, the future period is usually impossible to determine, and, in any event, future periods will receive benefit from the knowledge which results from many other expenditures customarily charged to income; and (2) that the element of continuing value is usually so intangible that its measurement is frequently difficult, and it is similar to ordinary intangibles not customarily recognized in financial statements. Furthermore, it is desirable, for federal income tax purposes, to secure the benefits of deductions for experimentation as the expenditures are made. While the tax rule is not always entirely clear, there is no question that a consistent policy of charging off such expenditures is helpful to the taxpayer in sustaining his position. It is one thing to finance experimentation currently out of funds in the treasury, but it is an added burden if these expenditures are not currently deductible for tax purposes. In the authors' opinion, deferment of development expenditures which relate to more tangible values is more defensible than to defer the cost of development of improved methods of production. Expenditures for improvement of land with a view to its subdivision and sale, for development of a new product, for a pilot plant, and for the exploration and development of mineral properties are examples of those that may be deferred.

Other Deductions.—Other deductions represent charges to income not related to normal operations, or financial charges for the cost of borrowed money.

Cash Discounts on Sales.—Some enterprises still classify cash discounts on sales as other deductions on the theory that they represent a financial expense, but most companies deduct them from sales.

Interest, Debt Discount, and Expense.—The determination of interest is usually a matter of simple arithmetic. Occasionally there are obligations upon which the interest is contingent, such as upon earnings, and interest should be accrued in accordance with the terms of the obligation. The amount of interest will vary slightly with different methods of computation used by banks, brokers, the United States Treasury, and others.

Long-term obligations are frequently sold at prices above or below face amount, giving rise to a premium or discount. This premium or discount should be amortized over the life of the debt by periodic credits or charges to income. Expenses of issue, such as legal fees, expenses of registration and underwriting, or brokers' fees should be treated similarly.

Unamortized debt discount, expense, and redemption premium on an issue which is being refunded may be charged off in the year of refunding or amortized over the remainder of the original life of the issue, but only under special circumstances should it be amortized over the life of the new issue unless the new issue has a shorter life than the old. Accounting for unamortized discount, expense, and redemption premium on bonds refunded and the related reduction in income taxes is considered in detail in Chapter 15.

Losses on Sales of Securities and Fixed Assets.—Considerations similar to those previously expressed with reference to profits on sales of securities and fixed assets apply to losses on these sales. However, the doctrine of conservatism dictates that probable losses be recognized, whereas probable profits are not. For instance, it may be desirable to recognize a loss even though the final steps in a sale have not been completed or to provide a valuation allowance in advance of an expected disposal, which is charged to other deductions.

Income Taxes.—Net income reported for any period should be after provision for the appropriate federal, state, or foreign income taxes. Many state taxes measured by income are franchise taxes in the eyes of the law and it is customary to include these taxes as a part of costs and expenses unless they represent true income taxes and are material in amount.

The difference between income for federal income tax purposes and as determined under generally accepted accounting principles may be great; the general increase in rates of federal income taxes in recent years and the imposition of high rates during the war created significant differences between taxes as computed on taxable income and the amount resulting from the application of tax rates to book income. The differences may be the result of extraordinary transactions which are carried to surplus, to a reserve, or to deferred charges in the accounts, but which represent taxable income or deductions from taxable income, or they may be the result of ordinary recurring transactions requiring annual adjustment for the tax returns. This subject was dealt with by the Committee on Accounting

Procedure of the American Institute of Accountants in Accounting Research Bulletin No. 23, issued in December, 1944. The effect of the Bulletin is that income taxes, to the extent practicable and reasonable, should be related to the income reported in the income statement. The Committee concluded that income taxes, like other expenses, are apportionable and should be apportioned between income and other accounts, when transactions resulting in a material increase or decrease in income taxes are not reflected in the income statement. This conclusion does not apply to transactions which involve normal and recurrent differences between book and taxable income.

Application of the rule laid down by the Committee results in:

1. The elimination from income and the allocation to surplus of the tax related to credits or charges to surplus;
   (a) When an item, which is credited to surplus, results in a material increase in income taxes, income should be relieved of and surplus charged with the amount of the tax increase. This was the practice to some extent prior to the issuance of Bulletin No. 23, and represents the application of a simple equitable principle.
   (b) When an item, which is charged to surplus, results in a material decrease in income taxes, surplus should be credited and income charged with the amount of the tax decrease. Thus income will be charged with an amount greater than the total income taxes for the period. This practice has not been approved by all accountants since the issuance of Bulletin No. 23 and was objected to by the S.E.C. in its Accounting Series Release No. 53. Objections to it stem from the belief that a negative amount of income taxes should not be apportioned.
2. The elimination from income or surplus of the tax effect of credits or charges not recognized therein;
   (a) When a material credit item is recognized as taxable income but is deferred in the accounts, it is proper to defer the recognition of the tax effect in income or surplus. In such circumstances it is proper to charge the taxes payable to the deferred credit account.
   (b) When a material debit item is deductible for tax purposes, but is charged to a reserve, deferred charge, or other asset account, the tax reduction should be eliminated from income and credited to the account originally charged. Thus debt discount or the cost of emergency

facilities, deductible for tax purposes but carried as assets in the accounts, may be reduced by the tax saving and future charges to income placed on an equitable basis.

3. The recognition in income or surplus of the tax effect of credits or charges thereto which are not currently recognized for tax purposes;
   (a) When a material credit item is taxable in other periods, it is appropriate to recognize the tax effect in the period in which it is included in income or surplus. For example, income from installment sales or from long-term contracts may be taken up currently but it may not be taxable until some subsequent period.
   (b) When a material reserve, not deductible for tax purposes, is set up out of income and when future charges to this reserve will be deductible, the amount of the reserve should be reduced by the estimated tax effect of the future charges; i.e., the reserve should be provided for the amount of the estimated future charges after deducting the related tax reductions.

The authors agree with conclusions reached by the Committee in Bulletin No. 23; they believe, however, that some of the conclusions, particularly those affecting the treatment of tax savings resulting from charges to reserves previously provided without regard for the tax effect of future charges thereto, for logical reasons could not always have been followed in the period immediately after publication of the Bulletin. The Committee's Bulletins are not intended to be retroactive and therefore need not be applied to transactions partly completed at the date of their issue.

The estimation of the present value of a future tax deduction, as for example in providing a reserve net after taxes on future charges, may be difficult but provision of the reserve on this basis is probably advisable, unless the future tax deduction is so doubtful that no provision should be made for it.

Corrections of previous years' estimates of income taxes should be charged or credited to income of the current year unless they are so material as substantially to distort current income. Reductions of income taxes resulting from the carrying forward or back of losses, as permitted by the Internal Revenue Code, are properly reflected in income of the year in which such losses are availed of as a tax reduction.

Provisions, Reserves, and Allowances.—Estimated provisions for probable costs, expenses, and losses are usually reflected in provision, reserve, and allowance accounts.

The following tabulation lists the more common provision, reserve, or allowance accounts which may or should be provided on the basis of past experience and reasonable future probability; it indicates the chapter in this book in which they are discussed and the usual disposition in the income statement of the charge for their creation:

Balance Sheet Item—Description of Provision, Reserve, and Allowance	*Where Customarily Charged in Statement of Income*
Accounts receivable (Chapter 10)	
Returns, allowances, and discounts	Sales
Bad debts	General and administrative expenses
Inventories (Chapter 11)	
To reduce inventories to an accepted basis	Cost of sales
Plant and property (Chapter 12)	
Depreciation and amortization (Chapter 13)	Costs and expenses or as a separate item
Marketable securities (Chapter 9)	
Loss or revaluation	Other deductions
Current liabilities (Chapter 16) and Contingent liabilities and reserves (Chapter 18)	
Losses on commitments	Cost of sales
Service or other costs under warranties	Cost of sales, or selling, general and administrative expenses
Litigation	Selling, general, and administrative or a separate item
Contingent or disputed taxes	Taxes or as a separate item
Maintenance	Costs and expenses
Self-insurance	Costs and expenses
Various contingencies	Costs and expenses or as a separate item

When provision, reserve, and allowance accounts have no definite or specific purpose, when they attempt to provide for losses or expenses of future operations, or when they reduce inventories or other assets to other than an accepted basis, provisions for them should not enter into the determination of net income. Bulletins Nos. 13, 26, 28, 31, and 35 of the Committee on Accounting Procedure, American Institute of Accountants, contain helpful discussions of the subject.

Net Income.—Accounting Research Bulletin No. 32, issued in December, 1947, considers transactions to be included in the income statement. In general, net income for any period should reflect all profits and losses recognized during the period, whether they relate to the period or not, except:

1. Extraordinary items when their inclusion would materially impair the significance of net income (see Chapter 7).
2. Adjustments resulting from transactions in the company's own capital stock.
3. Amounts transferred to and from accounts representing a segregation or appropriation of surplus or general purpose contingency or inventory reserves such as those dealt with in Bulletins 28 and 31.
4. Adjustments pursuant to a quasi-reorganization.

Consistency.—In Chapter 6 it is brought out that the selection of one accounting principle as opposed to another or the selection of one method of application of an accounting principle as opposed to another, may have little effect upon income over a long period of time but that within a single period the effect may be great. The importance of consistency and comparability in statements of income is largely because of the conclusions that the reader may draw from the statement. It is well known that market prices of stocks are based, to some extent, upon a capitalization of earnings and that they are also strongly influenced by the trend in a company's earnings. Any increase or decrease in earnings may be magnified in changes in stock prices and consequently it is important to the investor that these increases or decreases represent actual changes in earnings rather than the result of changes in accounting principles or methods of their application. While consistency is desirable, changes in principle and in methods of application may be made and, in fact, the average enterprise is continually making minor changes and may occasionally make a major change. It is important that the reader of the income statement be not misled by undisclosed changes or confused by frequent major changes.

In determining whether the accounts clearly reflect taxable income, the Bureau of Internal Revenue often considers consistency of treatment more important than the merits of a particular principle or the method of its application.

INTERNAL CONTROL

Basic Principles.—Good internal control of income has two objectives: to protect income against the omission of revenues properly receivable or the inclusion of improper costs and expenses, whether through fraud or inadvertence, and to increase the efficiency of operations. The devices used to attain one objective are frequently useful in attaining the other. For example, a budget may have as its primary purpose the reduction of expenses, but its proper operation will involve careful estimates of what expenditures should be made, analysis of actual expenditures, and explanation of the differences between the two. Under such circumstances it is difficult to conceal improper expenses of a material amount or to incur grossly wasteful expenses, particularly if responsibility for the operation of the budget and for the authorization of expenditures is properly defined. Internal control devices may operate within or without the accounting department but if possible they should be tied in with the accounts so that their operation is subject to accounting check. The features of internal control applicable to the various assets and liabilities, particularly of the current or working capital group, are closely related to if not sometimes indistinguishable from those applicable to income.

The basic principles of control of sales and revenues on the one hand and costs and expenses on the other are almost parallel, as indicated in the following summary.

Sales and Revenues	*Costs and Expenses*
1. Authorization	
Shipping orders should be issued on authorization of the sales department after approval of the sales by the credit department.	Purchase orders should be issued by the purchasing department after requisition by the production or other department.
2. Physical Evidence	
Evidence should be received from the shipping department of shipment of the merchandise, or there should be other evidence of value delivered.	Evidence should be received from the receiving department of receipt of the merchandise, or there should be other evidence of value received.
3. Invoice and Voucher Audit	
Invoices should be checked for authorization and evidence of shipment by an employee whose duties involve neither authorization nor shipping.	Vouchers should be checked for authorization and evidence of receipt by an employee whose duties involve neither authorization nor receiving.

4. Recording

Recording of accounts receivable is usually accompanied by the recording of a corresponding amount of sales or other revenues.

Recording of accounts payable is usually accompanied by the recording of costs and expenses or charges to asset accounts such as inventories, which charges find their way to income as the respective assets are sold, consumed, or expire.

Responsible personnel should review sales summaries prepared from invoice distributions. Informative sales classifications are important.

Responsible personnel should review voucher distributions and journal entries resulting in charges to costs and expenses. Informative classifications of costs and expenses are important.

5. Collections and Payments

Collections should be received by an employee whose duties are independent of the above procedures.

Payments should be made by an employee whose duties are independent of the above procedures, upon evidence that they have been performed.

6. Budgetary Control

Sales and revenues, and costs and expenses should be analyzed and summarized in groups corresponding to the division of responsibility for income and expenditures. Estimates or goals of accomplishment should be established and compared with actual results of operations and differences should be explained. Budgetary reports should be reviewed by the management.

7. Internal Reports

Operating statements prepared for the current use of management should be supplemented by reports upon those operations which are difficult to control, and these reports should be reviewed by the management.

8. Internal Audit

The efforts of the internal auditor should be directed particularly towards the examination of transactions which are not subject to automatic controls; with respect to the latter he should make sufficient tests and observations to assure himself that the purported controls are in fact functioning; and his examination should be coordinated with that of the independent public accountants.

Application of the above basic principles to individual enterprises is subject to considerations of economy and to individual requirements. Procedures of internal control are considered in greater detail below.

Sales.—When the size and kind of a business make it practical and applicable, the cycle of operations relating to the initiation and consummation of a sale normally should include the following steps: (1) receipt and acceptance of the customer's order, (2) preparation of a formal order and contract, if applicable, (3) confirmation of the order, (4) preparation of other supporting documents, including sales invoice, shipping order or advice, material requisition, and packing slips, possibly in one operation through the use of multiforms, (5) preparation of a production or purchase order if items requested are not in stock, (6) withdrawal of merchandise from stores, (7) shipment, (8) recording of the transaction and transmittal of invoice to customer, and (9) receipt of payment. The only steps which may not pertain to all sales are the preparation of the contract and initiation of a production or purchase order. The other steps should usually be followed consistently and controls should be established to insure that they are followed promptly and accurately.

Customers' orders should be reviewed by the sales or order department to determine that the material is available and that the terms are acceptable, and by the credit department whose function is to appraise the financial status of the customer, evaluate the risk involved, and set any desirable limitations of credit. The approvals of these departments should be indicated on the customers' orders. These departments should operate independently of each other.

Since purchase orders received from customers vary as to form, a standard order form, under numerical control, should be prepared by the sales or order department, in a number of copies sufficient for distribution to all parties concerned. The original should be retained in the sales or order department and on it should be recorded all information as to its current status.

On the basis of the approved customer's order, there should be prepared an invoice, stock requisition, shipping order, and packing slip, in sufficient copies and, when possible, in a simultaneous operation. Two copies of the stock requisition usually go to the storekeeper, one to be retained in support of the issuance of the material and the other to be forwarded to the billing department for subsequent comparison with shipping documents. The shipping department should retain the original shipping order, and return one copy

to the billing department containing all data relating to the shipment, such as date shipped, items, route, carrier, and any freight charges to be added to the billing. As an alternative to the last two steps, when the storekeeper does not retain a copy of the requisition he may forward the copy to the shipping department where the shipping data are added and the copy is then returned to the billing department. The billing department may then complete the invoice to conform with the shipping data, mail the original invoice to the customer, and transmit one copy to the accounting department for posting to accounts receivable.

Numerical control should be maintained over all customers' orders, shipping orders, and invoices, and correlated through adequate cross-referencing. Each department should maintain complete files of the principal documents relating to its functions. All invoices should be checked for accuracy of quantities billed, prices used, extensions, and terms prior to transmission to the accounts receivable department. The functions of stores, shipping, billing, and recording of the receivable should, whenever possible, be independently performed, but coordinated to produce a smooth flow of operations.

All classes of sales should be cleared and recorded in the same manner as sales to customers, including sales to employees, scrap and waste sales, equipment sales, and C.O.D. sales. They should be classified separately in the accounts and, when desirable, special approvals may be required.

Consignment Sales.—Consignments out should be included in inventories of the consignors. Records should be maintained for each consignee indicating an adequate description of the merchandise, its cost and selling price, as well as an abstract of the consignment terms. Periodic reports should be received from consignees of transactions in the merchandise which they are holding and these transactions should be reflected appropriately in the accounts. Confirmation of merchandise held should also be received periodically and periodic examination of these inventories by the consignor may be desirable.

Cash Sales.—Well-designed systems are available for the control of cash sales by means of serially numbered tickets or slips, and there are routines of inspection or checking to insure that merchandise is released only against the appropriate sales tickets. Cash registers are widely used in place of or in conjunction with sales tickets. When the cash sales volume is large, periodic and systematic internal audit is advisable.

Returns, Allowances, and Discounts.—A receiving report should be prepared for all returned merchandise, and copies should be sent to the sales and accounting departments containing information as to the reason for the return and its physical disposition. Credit memoranda for returns should be based on receiving reports and should be approved by a sales official and reviewed by a responsible accounting department employee. The employee originating credit memoranda should not have access to accounts receivable records. All rebates and special allowances, including freight, should be subjected to review and approval by an authorized employee. Trade discounts should be checked to standard terms at the time the invoice is prepared and checked.

Summaries and Analyses.—The classification of sales is an important feature of internal control, and the accuracy of sales classifications should be checked periodically by employees independent of those who make the original analyses—possibly by an internal auditor. Sales may be classified by type of product, by type of customer, by areas, or by salesmen. Each of these classifications may be used as a cross check; for example, when one type of customer receives a trade discount of a certain percentage, it may be feasible to prove the accuracy of trade discounts allowed by checking the composition of the gross sales and discount accounts in the particular sales classification and ascertaining that the over-all amount of discounts is the established percentage of gross sales.

Operating Revenues.—Revenues from services rendered by public utilities or from the sale of commodities which they furnish involve a type of control different from that in a manufacturing or merchandising concern. Their revenues are subject to metering or they may be controlled through the sale of tickets or tokens. To a greater extent than in commercial enterprises, revenues of public utilities are broken down into functional groups according to the type of service, classification, and location of customers, and the careful review of the revenue accounts is an important feature of internal control. Charges to customers are standardized in that they are based upon rates approved by regulatory bodies. The following outline lists some of the important controls which are applicable to revenues subject to metering:

1. All applications for service should be subject to review and approval before acceptance by the service and credit departments.

2. Procedures should be designed to insure the forwarding of all meter readings to the billing department.
3. Meter readers should not act as collectors and they should be rotated periodically from one route to another.
4. Periodic bills should be checked for accuracy of consumption, rates, and extensions before being mailed to consumers.
5. Meter history cards should be maintained and periodically checked to customers' ledger and route sheets to see that a customer is being billed for each meter in service, that meter constants (or multipliers) are correct, and that other pertinent data are in agreement.
6. Service cut-offs should be approved by a credit manager or other responsible official.

When tickets are sold by an agent, he may be charged with the face amount of the tickets delivered to him and must account for that amount in either tickets or cash. If tickets or tokens are sold by an employee who also receives cash from other sources, registers may be employed as an additional control. The average public utility is an enterprise large enough to employ an internal audit staff to make substantial detailed checks of its operating revenues.

Other Income.—The items which comprise other income may be regularly recurring in nature and subject to controls similar to sales or other operating revenues, or they may be sporadic.

Cash Discounts on Purchases.—The best accounting control to insure that all cash discounts are taken is to provide an account for discounts available when the invoice is recorded, which would be relieved when discounts are taken on payment of the invoice or when it is determined to forego the discount. Usually, however, the audit of invoices when vouchered and the audit of the voucher when paid will sufficiently assure that the maximum discounts are being taken.

Rents.—All real estate, equipment, or other assets for the use of which rental is received should be controlled through the maintenance of adequate records of their location, terms of rental, and payments due. The employee responsible for the collection of rentals should not have access to the controlling records. The income indicated by these records as due should be checked periodically to recorded receipts and any differences should be followed up promptly. It is also well for the records to include a summary of expenses in order to maintain proper control of net income.

Royalties.—A record should be maintained of the important terms of royalty agreements; this is frequently maintained by the legal department. Reports of licensees should be reviewed; sometimes these are subject to examination by independent auditors.

Interest and Dividends.—The employment of an independent custodian of investments, such as a bank or trust company, is in itself an important control in that the custodian usually has procedures to insure the receipt of all income due its custody accounts. However, whether or not such a custodian is employed, it is desirable and usually not burdensome to substantiate income from investments by computation of interest at established rates and by reference to published investment services which record the declaration of dividends. This audit function should be performed either by an internal auditor or by some designated employee who does not have physical access to the securities and does not participate in the accounting therefor. Interest from sources other than investments, such as from installment receivables, is usually subject to verification by computation.

Special Revenues.—Many enterprises receive revenues from activities such as cafeterias or clubs conducted for employees. While these revenues usually do not result in net income and the activities are frequently conducted at a loss as a matter of policy, gross revenues may be substantial. However, there is often a tendency to be lax in the maintenance of adequate records and controls of these revenues. The controls discussed for cash receipts in Chapter 8 and for employees' receivables in Chapter 10, may be applicable. Without going further into a detailed discussion of internal control of these activities, suffice it to say that they should receive the same attention as other departments of the enterprise and they should be controlled on a businesslike basis.

Costs and Expenses.—Since many expenditures initially give rise to assets such as inventories and are subsequently charged to income as the assets are sold or consumed, or expire, internal control of expenditures and of charges to income will be considered in this order.

Purchases.—The purchasing function should be divorced from that of accounting, receiving, stores, and shipping. The purchasing department should be headed by a responsible official well versed in purchasing techniques and procedures, who should approve all purchase orders issued. All purchases should be supported by a requisition, approved by authorized persons, which normally should not be initiated by the purchasing department. A standard purchase order,

bearing approval, and containing all information pertinent to the request for goods, should be prepared and copies of it should be distributed to all parties concerned. These orders should be under numerical control and filed by order number and possibly by vendor. While the distribution of copies will vary, a common distribution is as follows: (1) original and one copy to the vendor, the copy to be returned as an acknowledgment of the order, (2) one copy to stores, (3) one copy to the person initiating the request if other than the storekeeper, (4) one copy to the receiving department, whereby it may anticipate the receipt and have complete information as to specifications and description, facilitating adequate quality determination, (5) one copy to the accounting department against which the receiving report and vendor's invoice may be checked for quantities and terms as part of the voucher audit procedure, and (6) one or two copies to be retained in the purchasing department.

Adequate records should be maintained as to the status of unfilled orders to facilitate prompt follow-up. When applicable, all orders should be supported by complete data as to bids received and the basis for the selection of a particular vendor, to be subject to periodic review or audit, particularly when there are large contracts. All purchases made for employees should be cleared through the purchasing department in the same manner as other purchases. Procedures and controls relating to the receiving function were discussed in some detail in Chapter 11.

Effective procedures should be established for checking invoices and supporting documents by the accounting department before payment is made. Invoices and vouchers should be in agreement with purchase orders and the evidence of receipt of materials or services. Each invoice should be checked to determine the propriety of prices, terms, transportation charges, and other conditions agreed upon at the time the order was approved, and all mathematical computations should be proved. Before invoices are sent to the treasurer for payment, they should be approved by the executive in charge of the accounting department or some capable designee. The approval on vouchers or invoices should be based on careful review of all pertinent documents and should not be perfunctory.

The shipping clerk should keep a separate record of purchases returned to vendors and this record should be checked systematically to see that proper credits are received and reflected in the accounts.

Accounting distribution should be indicated by the accounting department and reviewed and approved by an authorized employee.

It is desirable, although not always feasible, to separate the functions of accounting and finance. This separation of the accounting from the handling of the funds deters possible embezzlements or frauds. When a check is presented for the signature of the treasurer or other officials approved by the Board of Directors, it should be accompanied by all evidence in support of the payment, which evidence should be checked as to its propriety before the check is signed. The voucher and supporting documents upon payment and prior to filing should be stamped or perforated in such a manner as to prevent their possible re-use. Chapter 8 contains a further discussion of the control of cash disbursements.

Pay Rolls.—The method of preparing the pay rolls should be so devised that the various steps involved are divided among a number of employees and each step is independently checked. The employment record which should be kept for each employee should show his rate of pay among other data; no additions or other changes should be made in this record without proper written authorization. In most large businesses this record is maintained by the personnel department. From time to time, the pay roll records should be compared with the employment records as to name, date when employee entered or left the service, and rate of pay. If possible, time clocks or other mechanical devices should be used in conjunction with time or piece-work records and these records should be checked periodically to production schedules and pay roll distribution records. An additional control feature of pay roll preparation is the rotation of employees' duties so that any abnormality should not go long undetected. A cardinal principle is that no person involved in pay roll preparation shall participate in any way in the disbursement of the funds.

If employees are paid by check, many of the controls applicable to check disbursements as discussed in the chapter on cash are applicable, namely, use of prenumbered checks, with control over all checks used; control over blank pay roll checks; use of a check protector; when a mechanical check signer is used, the operation of the machine should be under the sole control of the authorized employee; the retaining and filing of all voided checks—voided in such a manner as to prevent subsequent use; and control over old outstanding checks.

Pay roll checks should be signed and distributed by employees who do not participate in the preparation of the pay rolls, custodianship of cash funds, or the maintenance of accounting records. Use of an imprest bank account restricted to pay roll disbursements is desirable, and this account should be reconciled each month by em-

ployees whose duties are unrelated to the pay roll department or the issuance and signing of pay roll checks. Employees reconciling the accounts should receive the statements and canceled checks directly from the bank and their reconciliation procedure should include the checking of dates and names on pay roll checks against pay roll records and the examination of endorsements on checks.

When the pay roll is paid in cash, receipts should be obtained from employees and compared to pay rolls by employees independent of the pay roll department. Some system of identification of the recipients at the pay-off is always desirable.

Strict control should be maintained over unclaimed wages. A listing should be made of all pay envelopes not distributed and promptly turned over to the accounting department, and receipts for amounts subsequently paid should be examined by the accounting department. After a designated period unclaimed wages should be returned to general cash and a liability account for unclaimed wages credited.

Pay rolls should be audited periodically by someone independent of all pay roll functions, possibly by an internal auditor, and the examination should include, in addition to tests of the accuracy and propriety of the recordings, review of conformity with government labor legislation and accounting for liabilities incurred in connection with pay roll deductions. Reconciliation of pay rolls with salaries and wages included in the various social security and withholding tax returns may provide added assurance as to their integrity.

Other Expenditures.—Control procedures for purchases and pay rolls may be applicable to other expenditures since the latter may represent cost of materials or compensation for the services. On the other hand, other expenditures may be of a character to require entirely different types of control.

Freight and Express.—Since payments to transportation companies represent a class of expense which requires some specialized knowledge of tariffs, concerns whose business necessitates substantial expenditures for freight and express frequently employ a person skilled in these matters to audit freight and express bills. Some industries have a central association with a tariff bureau prepared to supply its members with various types of service and information. Where such services are available, they should be used.

As previously stated, invoice audit procedures prior to payment should include verification of transportation costs, delivery terms and allowances, and a check of rebillings of freight and express to cus-

tomers. The importance of the movement of materials and the related charges has manifested itself in the establishment by many companies of a separate traffic department.

Light, Heat, and Power.—Control over these expenses and their distribution may be facilitated through the use of meters which may be so placed as to record consumption for departments or functions. Monthly comparisons with budgeted consumption should be made to detect any abnormal usage not accounted for by changes in production. Periodic inventories of coal and other fuel supplies may provide an additional check on over-all use.

Repairs and Renewals.—Proper internal control entails a sound and consistent policy as to what expenditures should be treated as repairs and renewals and expenses and what should be capitalized. All requests for repairs should be approved by an official when the amount involved is significant. If amounts are not significant, approval by a department head may be sufficient. If repair work is to be done by the company's employees, an authorized work order should be prepared and all labor, material, and overhead charges applicable thereto should be accumulated. If services are rendered by an outside contractor, the work performed should be inspected carefully prior to payment of billing. All charges of either an expense or capital nature should be reviewed by someone independent of operations as a check on the propriety of the accounting distribution.

Administrative and Officers' Salaries.—Annual compensation for all officers and any special compensation such as bonuses or profit-sharing distributions should be approved by the Board of Directors. As to other personnel, a system of authorization for increases is usually desirable wherein approval at varying levels of authority may be required depending on the size of the increase and the total wage. For example, increases may be authorized by department heads so long as the total earnings of no one employee exceeds a specified amount and the total budget allowance for the particular department is not exceeded. Any increases in excess of the specified amount may require the approval of a vice president or some other high ranking officer and possibly the Board of Directors. For additional control features see the discussion above under "Pay Rolls."

Office Supplies.—Adequate control over office supplies should include centralization of both the storage and purchase authorization functions. Centralized storage will avoid duplication of inventories in various departments, enable the employee responsible for their

purchase to determine more accurately his requirements, and prevent the excessive accumulation of forms and supplies. By centralizing the authorization for purchase in one person, economies of quantity purchase may be gained and opportunities for standardization of forms may be substantially enhanced.

Postage.—To avoid minor defalcations with respect to postage, the installation of postage meter machines is suggested. A daily mail book showing the total postage used on outgoing mail requires very little time to compile and is frequently a valuable record. It affords an opportunity to apportion costs to various accounts and departments and results in greater care and awareness by all concerned when someone in authority from each department is required to initial the charges to that department at least weekly. When the cost of shipping is to be borne by the purchaser, control should be exercised over mail charges on goods shipped to insure their inclusion in billings to customers.

Telephone and Telegraph.—Long distance telephone calls and the use of the telegraph should be restricted to approved personnel in each department. In addition, records of these expenses, broken down by departments and possibly by individuals, should be kept as a means of detecting the possible extravagant use of these facilities. The installation of a pay-station may be helpful in discouraging personal telephone calls. When personal calls are permitted, accurate records should be maintained and collections should be made promptly.

Insurance.—Expenditures for insurance should be properly authorized and policies should be reviewed by someone in the organization familiar with insurance matters as assurance that the desired coverage has actually been effected. An insurance register should be maintained, recording by policies the type, amount, and period of coverage, premiums paid, amounts prepaid or accrued at the beginning and at the end of the period, and amounts charged to expense during the period. Policies should be reviewed periodically for reasonableness of rates, adequacy of coverage, dividends due on mutual policies, and possible credits due on canceled policies.

Rents and Royalties.—All rent and royalty expenses should be supported by leases or contracts entered into by an official of the company. Normally rent, except when based on units of production or some other special consideration, can easily be scheduled and controlled. Royalties may be computed on special bases and both the

bases of the computations and the computations themselves should be checked by an authorized employee.

Salesmen's Salaries and Commissions.—Even within the same company, contractual agreements with salesmen may not be identical. Such factors as the varying profits of different lines, the territory to be covered, and the amount of sales effort required contribute to the need for individual arrangements. Such a diversity necessitates careful review and periodic internal audit of pay rolls to determine that provisions of the agreements pertaining to the determination of compensation are being considered.

Traveling and Entertainment.—Control over these expenditures is dependent to a large degree on the extent of the detail and supporting evidence the employee is required to furnish in support of his report of expenses. Generally, the more exacting the requirements for supporting data, the better the control. Sometimes standard allowances for meals, hotels, and miscellaneous expenses are a satisfactory means of control and serve to reduce the necessity for detailed examination. However, policies may vary substantially in different companies and the requirements for submission of detailed expense accounts may be curtailed for the more responsible employees.

Vouchers for reimbursement should be approved, prior to payment, and advances should be accounted for. In some instances it may be appropriate to confirm advances periodically.

Taxes.—Many large enterprises maintain a tax department which prepares or supervises the preparation of all tax returns and maintains the required analyses and information. The scope of operations of a tax department and the amount of outside counsel which it may require will naturally vary with the tax and accounting complexities and the ability of the personnel. The present high rates of income taxes make it obvious that good control must be exercised over what may be the largest single expense of the business.

The differences between income for tax purposes and income as determined under generally accepted accounting principles may make desirable an extensive set of supplementary records to facilitate the preparation of tax returns and to identify clearly the allowable costs and other deductions.

Journal Entries.—While many costs and expenses are charged directly to income when the expenditure is made, in many enterprises the majority of expenditures are initially charged to asset accounts and costs and expenses are subsequently recorded as charges to in-

come through the medium of journal entries. These journal entries reflect the sale of inventories, the absorption of prepaid expenses, the accrual of taxes, and the like. It is important that responsible employees originate journal entries, that they are properly reviewed and approved, and that the employee originating them does not have physical custody of the assets which he may be charging to expense or is not otherwise in a position to benefit from an expense charge. Many frauds have been concealed by improper journal entries. Mechanical control of journal entries includes assignment of standard numbers for recurring transactions to assure their inclusion each month and a numerical control to assure posting.

Cost of Sales.—As stated in Chapter 11 it is a principle of good internal control that the cost of goods manufactured be determined by an adequate cost system. Under such a cost system, cost of sales for any period ordinarily represents the sum of (a) the inventory cost of goods sold during the period, (b) the difference between cost of production and inventory cost, such as unabsorbed overhead and other cost variations and (c) inventory adjustments, such as reduction of inventory cost to market, write-downs or write-offs of obsolete inventory, or recognition of shortages.

Charges to cost of sales for the inventory cost of goods sold during the period usually can and should be related to physical shipments. Cost of sales entries usually originate in the cost section of the accounting department and quantities and costs may be checked or test-checked internally to records of units shipped and to inventory prices. It is important to prevent cost of sales from becoming a dumping ground for unrelated charges; serious defalcations have been covered up in this account. Entries reflecting the difference between production cost and inventory cost and inventory adjustments should also originate in the cost section; they are subject to the controls outlined in Chapter 11.

Other Costs and Expenses.—Other charges to income through the medium of journal entries will commonly include (a) the absorption of prepaid expenses such as insurance and taxes, (b) the usage of expense inventories, (c) traveling and other expenses from funds advanced to employees, (d) depreciation and amortization of plant and other assets, (e) provision for and writing-off of bad debts, and (f) the reflection of accrued taxes, insurance and other expenses in current liabilities. Without further amplifying the principles of internal control set forth above, it is appropriate to emphasize the importance of an orderly scheme of accounting for these items,

including a systematic review of them since these entries are too often taken for granted.

Budgetary Control.—A budgetary system has, in recent years, become more generally recognized as an effective device in the attainment of efficient operation, even in small companies. Circumstances may be such that a comprehensive budget plan is not economically feasible and certain phases of the program may be limited. Therefore, the discussion contained herein relates to the more general features of a budget plan.

Budgetary control requires first, the selection of a budget supervisor, responsible for the compilation and administration of the budget and the reporting thereon; second, the establishment of budget figures or standards (these normally originate with the departmental supervisors and are transmitted to the budget supervisor or budget committee for review and appraisal before inclusion in the budget); third, the use of an adequate chart of accounts so arranged as to facilitate comparisons between actual and budgeted figures; fourth, the use of appropriate forms and reports for periodic reports to management which contain explanations of variations between budgeted and actual results and other appropriate comments; and fifth, and most important, the effective use of the budget by management.

The period of time for which a budget is prepared will vary, particularly in a business of a seasonal nature. The sales budget should consider production factors, such as available labor and the capacity to produce. Since all phases of the budget program are directly related to sales, the budget must be sufficiently flexible to permit prompt adjustment when sales trends differ from those originally anticipated.

The various budgets normally prepared in arriving at an over-all budget are those for revenue, production, purchasing, inventory, labor, factory expenses, selling and administrative expenses and capital expenditures. In addition, special financial budgets relating to the receipt and disbursement of funds, and forecasted profit and loss statements are frequently prepared.

Budgetary control formalizes the company's proposed plan of operations, fixes responsibilities, and may localize certain weaknesses in operations which, when brought to the attention of management, may be corrected with considerable financial saving. For example, comparison of budgeted sales figures with actual may suggest changes in the production program or, conversely, when production costs of certain items far exceed the estimates, the sales policy may be altered.

The budget contemplates the existence of a suitable expense classification so that a clear segregation can be made of the expenses which are subject to direct control, by shop foremen or department supervisors. When monthly reports are prepared to show actual performance in comparison with the budget, the controllable manufacturing expenses will be shown apart from those expenses which are fixed costs of plant operation, such as rent, depreciation, taxes, and insurance, or are not those of manufacturing.

Internal Reports.—In addition to current income statements prepared for the use of management, usually issued monthly, it is frequently customary to prepare analyses of sales, production costs and expenses, and other accounting or statistical data. Whether or not these reports are prepared on a budgetary basis, they may be of great value to management if properly interpreted and acted upon. Some of these reports may be very detailed and if they are to be used effectively it is important that they be reviewed and condensed or summarized before consideration by top management. In addition to increased efficiency in operations which may result from management's evaluation of internal reports, the increased knowledge of the contents of accounts which management gains from the review of these reports may prevent losses through fraud or waste.

Internal Audit.—The internal auditing department should direct a large part of its efforts to the examination of the operating accounts, particularly those accounts in which there are weaknesses in internal control. The adequacy and functioning of the system of internal control in protecting income should also receive the attention of the internal auditors, and this part of their work, if well done, can be very effective. In some respects, the program of the internal auditors will resemble that of the public accountant but it will usually comprehend a more detailed examination of transactions; it is not considered necessary here to discuss specifically the internal audit program. Integration of these programs will usually achieve a more comprehensive and more efficient examination of income than that of the public accountant alone and will promote the proper functioning of the system of internal control.

AUDITING PROCEDURES

Objectives.—In the majority of cases the auditor assumes the responsibility of making such an examination of the statement of

income that he may form a well founded opinion that, together with the statement of surplus, it presents fairly the results of operations for the period. The auditor's examination of the income statement necessarily differs substantially from his examination of the balance sheet, since his examination of the income statement is not so detailed that he can assume the same degree of responsibility for classification of the items as he customarily does with respect to the classification of items on the balance sheet. Even in a small concern, the volume of transactions may be so great that an examination of the majority of transactions would be prohibitively expensive, if not impossible. Aside from considerations of expense, it is not usually necessary or desirable to make a detailed audit of income, since the technique of reviewing and testing, when skillfully applied, produces the desired results. It follows that while the auditor does not attempt to ascertain that all items of income and expense are properly recorded, he should receive reasonable assurance from his examination that, in all material respects and in accordance with generally accepted accounting principles, the statements of income and surplus present fairly the results of operations.

Basic Procedures.—Basic procedures of the auditor's examination of the statement of income consist of:

Examination of the related balance sheet accounts,
Review of the system of internal control, and
Review, analysis, and test of the operating accounts.

Examination of Related Balance Sheet Accounts.—Theoretically, proper statement of the balance sheet accounts at the beginning and at the end of the period will insure that the reconciling amount of net income is necessarily properly stated in accordance with the accounting principles followed in preparing the balance sheets. This proposition is true, except for possible confusion between income and surplus charges and credits, and except for the unrecognized effect of changing price levels. In practice, examination of income and expense accounts frequently leads to corrections of balance sheet accounts.

Examination of the balance sheet accounts also tends to establish the integrity of the related accounts in the income statements; this has been indicated in some of the preceding balance sheet chapters. It may be helpful to present a brief summary of this relationship.

Sales and Operating Revenues.—Examination of (1) accounts receivable and inventories should establish that proper cut-off of

sales was observed and confirmation of receivables tends to establish the validity of sales; (2) cash receipts, particularly from the point of view of control, will tend to support the fact that cash sales were properly recorded; and (3) provisions for returns, allowances and discounts insure that sales are not overstated in these respects.

Costs and Expenses.—Examination of (1) accounts payable and accrued liabilities should establish that all ascertainable costs and expenses have been initially recorded; (2) inventories establishes in large part the propriety of cost of sales; (3) prepaid expenses and deferred charges insures that income has been charged for the absorption of these items and that proper charges to current income are not deferred; (4) plant and depreciation reserve accounts supports the charges for depreciation and gives assurance that maintenance expenses have not been improperly capitalized; and (5) provision for taxes and various reserve accounts identifies the proper charge in income.

Closely related to the above auditing procedures, which more or less accomplish the objectives of both the balance sheet and the income examination, are those undertaken concurrently for purposes of convenience, such as the substantiation of interest and dividends from investments at the time the investment accounts are examined; these procedures will be discussed in this chapter.

Review of Internal Control.—In his examination the auditor should arrive at a conclusion as to the extent he is justified in placing reliance on the client's system of internal control as assuring proper classification of income and expenses, as well as assuring the integrity of the amount of net income for the period. Consequently his review and evaluation of the system of internal control of income accounts as well as of related balance sheet accounts is of primary importance. He may first determine what procedures appear to be applicable and then make tests to find whether they are actually in force. A series of transactions may be followed from inception to consummation and supporting data examined at the various stages. The auditor's review of internal control procedures should precede, but should also continue through, his review, analyses, and tests of the various operating accounts; important deficiencies may call for extension of audit procedures. The public accountant should examine analyses and reports of internal auditors, appraise their value, and, when he considers internal audit procedures adequate and effective, he may reduce his audit procedures because of them. The work of the internal auditor should not be considered as

a substitute for that of the public accountant, but rather as a factor of the client's internal control, which may permit the public accountant to reduce the amount of detailed checking otherwise necessary.

Review, Analysis, and Test of the Operating Accounts.—One of the most effective procedures of the public accountant is the review of the client's detailed internal reports and comparison of the individual operating accounts with those of prior periods. Review of budgetary reports may also be extremely helpful.

The public accountant prepares, or asks his client to prepare, analyses of those accounts for which he requires further breakdown. Preparation of these analyses by the client usually results in substantial savings of the auditor's time. If the client prepares them, he will usually see to it that the accounts are maintained in sufficient detail to facilitate analysis. Analyses prepared by the client may be reviewed, checked, or test-checked by the auditor as the circumstances indicate.

There are two methods of selecting the area for detailed tests of underlying transactions: certain accounts may be analyzed and substantial portions of the supporting original documents examined; or a period or periods may be selected and, irrespective of the accounts involved, original documents, journal entries, postings and footings in those periods checked. Either method should be coordinated with the review of internal control.

Frequently an operating account can be substantiated approximately by an over-all computation; any substantial variation between the computation and the recorded amount should be investigated.

Sales.—The auditor's examination of the details of sales and related returns, allowances, and discounts does not usually cover an extended period or a large percentage of the transactions. He places his chief reliance upon his evaluation of internal controls, his examination of receivables and inventories, and his over-all review of the sales accounts.

The auditor may prepare, or procure from his client, sales analyses broken down by principal products or other logical classifications, showing gross sales, returns, allowances, discounts, and preferably cost of sales and gross profit. These analyses may be prepared by months and compared with comparable figures for the previous year. The auditor then can investigate unusual trends in sales or unexplained variances in profit margins.

After the auditor has acquainted himself with the order, billing, and shipping procedures and related controls he may undertake a

limited detailed examination of sales, selecting either a period for all sales accounts or certain accounts for more extended periods. Since the chief value of such an examination is ordinarily in ascertaining whether good procedures and controls are in force, it is more important to examine fewer original documents with great care than to cover a large number of transactions at the sacrifice of thoroughness. The examination may include the following auditing procedures for the period chosen:

1. Foot the sales recapitulation.
2. Trace postings to the sales and receivable controlling accounts.
3. Account for the numerical sequence of all or a portion of the invoices.
4. Check or test-check prices and computations on the invoices.
5. Compare or make test comparisons of quantities on the invoices with advices from the shipping department, transportation receipts, and customers' orders.
6. Compare or make test comparisons of amounts in the invoices with entries in the sales recapitulation and the individual customers' accounts receivable.

The auditor should take steps to assure himself that a proper cut-off of sales is made at the end of the accounting period. Shipping advices may be numbered in the order in which shipments are made. If they are, the auditor should examine invoices recorded a few days prior to and a few days after the end of the period to ascertain that transactions of the period include all invoices recorded by the shipping department as shipped before the close of the period, and no others. Under other systems, other methods may be necessary. The examination of inventories and the confirmation of receivables at the end of the period offer additional assurance of a proper cut-off. In any event, the auditor should be alert for sales which have been recorded but not consummated, such as predated invoices for merchandise to be shipped in a subsequent period, particularly when bonuses are based upon sales or when the auditor has grounds to suspect that the financial statements are being dressed up.

One of the best methods of sales verification is the correlation of units produced, adjusted by opening and closing inventories, with units sold. This correlation is not always possible; it is usually practicable when the products are few and prices uniform. It may be helpful even on the basis of an approximate computation.

In his examination of sales, the auditor may find helpful the comparison of certain ratios with those of prior years. He may review monthly sales reports prepared for management's use and the accompanying explanations of unusual fluctuations contrary to either the normal seasonal or the current business trend.

Returns, Allowances, and Discounts.—The analysis of sales previously mentioned, prepared by the auditor or the client, should include analyses of returns, allowances, and discounts. The auditor may compare the ratio of these to total sales from month to month or from period to period and obtain reasonable explanations of unusual fluctuations in the ratios.

A detailed examination of returns, allowances, and discounts may include the following procedures for the period chosen:

1. Obtain a recapitulation of the credits issued or refer to the credit register if one is maintained. Prove or test footings and trace postings to accounts receivable and returns, allowances, and discounts controlling accounts in the general ledger.
2. Check or test-check the numerical sequence of credit memoranda. Compare or make test comparisons of the credit memoranda with the recapitulation or credit register.
3. Test a representative number of credit memoranda for authorization and inspect evidences of receipt of returned merchandise.
4. Ascertain that merchandise returned by customers for credit is charged to the proper inventory account with a corresponding credit to cost of sales and that these charges and credits are correlated with corresponding entries in returns and allowances and accounts receivable.
5. Check or test-check credits recorded in the register or recapitulation to customers' accounts and make test comparisons with original invoices to customers.
6. Select a number of customers' accounts receivable and check credits appearing thereon to approved credit memoranda.

Credits issued after the end of the accounting period should be examined to determine the extent to which they may affect sales for the period under review and the auditor should consider whether allowance for them is necessary. If returns are excessive, shipments unauthorized by customers may have been made prior to the end of the period to inflate sales and increase reported profits. Review of the

supporting evidence for these credits may indicate that merchandise was returned prior to the year end and included in inventory and that the sale should be reversed. Excessive returns may indicate a defective product, with consequent effect on inventory pricing, and liability for costs to remedy the defects.

The client's discount policy should be reviewed and the terms of any special agreements noted. In addition to the investigation of unusual fluctuations a test may be made of the discounts allowed to a representative number of customers or for a selected period. Provision should be made for substantial amounts of trade or quantity discounts which will be allowed to customers on sales made during the period. It is good practice but not obligatory to provide for cash discounts.

Cash Sales.—When the volume of cash sales is large, the auditor's examination of related internal control and accounting procedures should be thorough. Imperfections in the internal control of cash sales may have more serious consequences than those of credit sales. The circumstances surrounding cash sales vary greatly and it does not seem appropriate to include here a detailed outline of the procedures of an examination of cash sales. It is often possible to make over-all checks of cash sales, even if sales are also made on credit, and these, in conjunction with reasonably good control, may give satisfactory indication that misappropriations, if any, are not significant in amount.

Even though the records indicate few cash sales, the auditor should not be satisfied without further inquiry. In one instance the auditor found that practically no cash sales were recorded. He was informed that it was not the custom to make such sales, but further investigation developed the fact that cash sales had been quite frequent and that his first informant had pocketed the proceeds.

Consignment Sales.—Consignment sales are, in fact, not sales, but inventories held by the consignee for the account of the consignor. Goods on consignment should be confirmed by the consignee and, if material in amount, they should be physically inventoried periodically by the client. It is often desirable for the auditor to observe this physical inventory-taking. The inclusion of shipments on consignment in regular sales will ordinarily be revealed by the confirmation of receivables. The auditor should review agreements with consignees and test recorded sales against consignees' sales reports.

C.O.D. Sales.—Aside from a review of procedures and controls peculiar to C.O.D. sales, there are no auditing procedures involved

which are different in principle from those applied to other sales. In conjunction with his examination of inventories and receivables the auditor may investigate the ultimate disposition of C.O.D. shipments undelivered at the balance sheet date and consider the necessity for a provision for returns if these shipments are recorded as sales.

Installment Sales.—Audit procedures in the examination of installment sales usually include confirmation of a portion of the receivables, examination of supporting documents, such as conditional bills of sale, serial notes, and the like, and tests of footing and summaries of these sales. Under the installment method of recording profits on installment sales, the gross profit credited to current income and charged to deferred income is the same amount as in the previous month, adjusted by the addition of gross profit on installments due on new sales and the subtraction of gross profit on installments fully paid in the preceding month. The auditor should review the apportionment of installments due between current and deferred income and the apparent adequacy of provisions for default.

Operating Revenues.—One of the characteristics of the average electric or gas utility company is that it serves a great number of small customers and a small number of large customers; also its revenues are billed to customers and are not initially collected in cash. Internal control is usually good and may include a substantial amount of internal audit. Therefore, the auditor customarily confines his examination to a small portion of the revenues and relies to a greater extent upon internal control and upon analyses and over-all tests, than in the average commercial concern. One or more billing centers may be selected for a test examination, including the confirmation of accounts receivable; the chief purpose is to determine that established controls and procedures are in force. Over-all review of operating revenues will usually include tests of their summarization and investigation of major fluctuations. Variations in revenues are usually watched closely by management.

Characteristics of other utilities will vary, and the auditor's approach may be basically the same as for the electric or gas utility or it may resemble more closely the examination of sales in a commercial concern.

Operating income of enterprises other than public utilities may range from items which are tantamount to small cash sales controlled by tickets or by registering devices, to amounts which are rentals for real or personal property and it is not considered feasible to

consider here the different kinds of auditing procedures which may be applied in their examination.

Other Income.—By its nature, other income is usually more readily subject to verification than operating income and it is therefore incumbent upon the auditor to make such over-all tests as are reasonable in the circumstances.

Cash Discounts on Purchases.—The auditor should ascertain whether payment procedures take full advantage of all discounts. He may review the ratio of discounts to purchases and compare this ratio with that of the preceding year. If no account is maintained for discounts lost, the auditor may note from the many vouchers which he examines in the course of the audit whether any significant amount of discounts has not been taken.

Dividends and Interest.—Dividends and interest from investments are ordinarily examined in conjunction with the examination of the related balance sheet accounts. Analyses of the investment accounts should include the necessary information to enable the auditor to check investment income. Dividends are usually checked by reference to independent reporting services and particular attention should be paid to stocks purchased or sold close to the record date. Interest on investments should be verified by computation of interest due at established rates. Other interest should be computed or subjected to appropriate tests.

Rents.—The auditor should prepare or obtain from his client a summary of rental properties and of rents receivable from each property; this summary may also indicate the rent due during the period. The auditor should examine related leases or, if leases do not exist, review informal rent agreements with someone in authority who preferably is not connected with the receiving of rents. Floor plans of buildings may be checked to see that all space is accounted for, vacancies may be checked by a visit to the premises, and rentals received may be tested by confirmation from the tenant. The auditor will usually be able to determine that substantially all rents due have been received or are receivable.

When collections and leasing of properties is in charge of a reputable agent, it may not be necessary to examine the transactions in detail if the agent's reports are comprehensive and are reviewed by a responsible person within the client's organization. If any doubts exist as to the authenticity of the reports, the transactions may be confirmed directly with the agent.

Frequently a lease requires a deposit by the lessee as a guaranty of performance. If such deposits are specified in the lease their existence and proper treatment in the account should be substantiated.

Royalties.—Royalty contracts should be examined and pertinent data on rates, reports required, effective dates, and methods of settlement noted. Usually the terms of the royalty agreement call for periodic reports from the licensee and the income received or accrued will be based upon these reports. If the reporting date and the date at which the financial statements are being examined do not coincide, as a practical matter the auditor may often ignore royalties accrued from the date of the last report. Reports received from the lessee during the fiscal period should be reviewed and the computation of royalties due should be checked against terms of the agreement.

Profit or Loss on the Sale of Fixed Assets and Securities.—The auditor should check profits or losses on sales of fixed assets and securities in conjunction with his examination of fixed asset and investment accounts. He should satisfy himself that they are properly computed.

Costs and Expenses.—As previously indicated the auditor's examination of sales and operating revenues is usually not detailed and his chief reliance is upon internal controls, examination of related balance sheet accounts and an over-all review of the sales accounts. This is also true of his examination of costs and expenses but, because there is usually greater diversity in the nature of costs and expenses than of sales and operating revenues, and therefore in controls as well, the auditor usually spends more time in auditing costs and expenses than in auditing income.

As in his examination of sales and revenues one of the auditor's first steps should be to obtain analyses of costs and expenses, classified in groups appropriate to the particular business being examined and preferably giving monthly figures in comparison with those of the previous year. The auditor should familiarize himself with procedures and controls underlying purchases, pay rolls, and other expenditures and in the origination of the journal entries for cost of sales and other expenses.

It may be that at this point in his examination, the auditor will be able to arrive at a conclusion as to which accounts require further analysis or substantiation by examination of vouchers or underlying data and the extent of his test examination of vouchers, journal entries, postings, and footings. If the auditor has prepared the

analyses himself by reference to vouchers and journal entries, no further tests may be necessary. His analyses may automatically check footings and postings. If the analyses are prepared by the client, sufficient tests should be made to substantiate their integrity.

VOUCHERS.—Most businesses maintain a voucher register to record not only purchases of materials but also the incidence of practically all liabilities which are to be discharged currently by cash payments. The auditor should usually check the voucher register for a selected period by:

1. Comparison of approved vouchers with supporting data, such as invoices, reviewing the general propriety of the payment, and noting the propriety of the accounting distribution.
2. Comparison of vouchers with entries in the voucher register.
3. Check or test-check of footings of the voucher register.
4. Tracing postings from the voucher register to the general ledger.
5. Comparison of voucher register entries with entries in the cash disbursements record and paid checks.

Occasionally vouchers cannot be located. Unless the number of missing vouchers or the amounts involved are comparatively large, or the explanations obtained from officers or employees of the client are unsatisfactory, the auditor should not regard the failure of the client to submit every voucher as serious. Experience indicates that in normal business operations the temporary mislaying or misfiling of an occasional voucher is to be expected, and that when an employee enters an irregular or wholly fictitious payment he is usually careful to have it supported by an authentic-looking voucher. However, the auditor should satisfy himself that material items for which he fails to find vouchers are properly supported by correspondence or other documents in the files.

Occasionally adequate vouchers are not available to support charges to expense accounts and, upon inquiry, the auditor may be told that the disbursement represents confidential bonuses or commissions, legal expense, dues, contributions, or other expenditures with respect to which it is not considered desirable to include details in the regular files. The auditor should obtain approval of the expenditure from at least as high an authority in the client's organization as would have authorized the payment on a formal voucher had one been prepared. The auditor is not a detective or a prosecutor, but since transactions which depart from the usually prescribed routine may open the door to irregularities on the part of employees, he

should be careful to assure himself that such disbursements are made with the knowledge and approval of high company authority. It may well be that the auditor should secure approval of the Board of Directors of questionable expenditures significant in amount.

It may be desirable for the auditor to keep the vouchers and the voucher register under his control until he has completed his examination of them or to take other steps to prevent a client's employee from forging a check mark on the voucher register to indicate that the auditor has examined a voucher. If vouchers are not canceled upon payment, the auditor should be upon his guard for indications of their re-use.

The auditor's procedures in determining that all invoices have been entered at the end of the accounting period are outlined in Chapter 16.

Invoices for goods or services purchased should be in the name of the client and not in the name of its officers or employees, unless, as a matter of policy, employees are being afforded the advantages of the company's purchasing facilities to obtain better prices. In any event the auditor should be on his guard to detect improper disbursements of the client's funds for the benefit of employees.

Purchases.—A detailed examination of purchases may include the following procedures:

1. Check the mathematical accuracy of the invoice.
2. Examine the related purchase order, comparing prices, quantities, and terms; see that the request for issuance of purchase order originated from a proper source and that the purchase order is properly authorized under the customary procedures.
3. Examine the related receiving report, noting date, quantities, and signature of authorized recipient.
4. Observe that there is evidence of audit of the invoice prior to payment.
5. Determine the propriety of the accounting distribution.

Pay Rolls.—One or more of the pay rolls in the period under examination may be selected for detailed examination, depending upon the number of persons employed and the degree and effectiveness of internal control. Suggested procedures to be followed in a pay roll examination are as follows:

1. Compare the names appearing on the pay rolls with personnel records or other satisfactory evidence of employment.

2. For employees paid on an hourly or piece-work basis, check pay roll hours or production by reference to time clock cards, production tickets, or other supporting data.
3. Verify rates of pay by reference to approved schedules of hourly or piece-work rates, or to approved salary schedules.
4. Test computations of gross pay and net pay.
5. Substantiate deductions by computations or by reference to proper authorization.
6. Test pay roll extensions and footings.
7. Compare the net pay roll amount with the disbursement voucher and trace the various totals to the proper accounts.
8. Compare canceled checks, receipts, or other evidence of payment with the names and amounts appearing on the pay roll.
9. When possible attend and control a pay-off and observe the controls in pay roll disbursement procedures.

Other Expenditures.—A detailed examination of other expenditures may follow the scope indicated for purchases or for pay rolls or the examination may be conducted along different lines. The important thing to keep in mind is that the primary purpose of the examination is to determine that procedures of accounting and of internal control are satisfactory; that expenditures are properly authorized, are made only on evidence of receipt of goods or services, are subjected to adequate internal examination, and are properly recorded in the accounts.

Journal Entries.—The auditor's examination of journal entries may be through the analysis of many accounts or a test review of journal entries for a short period. As stated previously, journal entries are often the source of the major portion of the charges to income for costs and expenses and they may produce errors or may be utilized to conceal fraudulent transactions. The auditor should not consider that his tests are complete until representative journal entries have been examined.

Cost of Sales.—In his examination of inventories, as outlined in Chapter 11, the auditor may have obtained or prepared inventory analyses which indicate the portion of inventories charged to cost of sales, as well as any portion of production costs not chargeable to inventories, such as unabsorbed overhead, and inventory write-downs. If these analyses are available, they should be compared with cost of sales as it appears in the income statement. The auditor may

have reviewed monthly fluctuations in gross profit in connection with the sales analysis referred to in this chapter and have compared gross profit with that of the previous year; such a review preferably should be made on the basis of gross profit before such items as unabsorbed overhead and cost variations. Factory overhead is usually substantial in amount and composed of a number of different kinds of expenditures. An analysis of it is often desirable. Too often the auditor underestimates the importance of the examination of factory overhead because it loses its identity in a cost system. The discussion of inventories and cost of sales assumes that an adequate cost system is in operation; if there is not a satisfactory cost system, audit procedures should be adapted to the circumstances.

The auditor's detailed examination of cost of sales for a selected period may include the following procedures:

1. Ascertain by test that the sale of inventories results in charges to cost of sales. These tests may be limited when the accounting system is such that the physical shipment should automatically result in a cost of sales entry.
2. Check or test-check the application of cost to shipments.
3. Examine other charges to cost of sales, such as unabsorbed overhead and inventory write-downs.

The correlation of units produced with units sold previously described as a procedure in the examination of sales may be amplified to substantiate cost of sales as well as sales, by extending the units sold at cost. This procedure is possible only under special circumstances, but the possibility of making it should not be overlooked.

The auditor may review the cost of sales account for the period and determine the propriety of entries unusual in amount or in source.

Other Costs and Expenses.—The auditor may obtain or prepare analyses of other costs and expenses similar to those of sales and cost of sales. These should be reviewed and unusual fluctuations from other costs and expenses of the previous month or of the previous year should be investigated.

In most well-ordered businesses, expense accounts will be maintained in sufficient detail to facilitate such a review and the auditor's efforts will be directed to examination of sufficient individual items to establish the validity of the account classifications and to examination of important individual vouchers. Since the auditor's examination of the different expense accounts will vary considerably, depending upon the circumstances, it is not practicable to summarize

the procedures in detail. In the following paragraphs some of the procedures in the examination of certain costs and expenses are discussed.

Freight.—The auditor is not expected to be an expert on freight rates. However, if he is not satisfied that freight bills are being satisfactorily reviewed by reasonably well-informed personnel he should suggest improved procedures. In making a test examination of freight expense the auditor should ascertain whether freight on incoming materials is paid by the vendor when terms are f.o.b. destination and whether customers are charged with freight on outgoing shipments f.o.b. factory.

Depreciation and Amortization; Maintenance and Repairs.—Examination of provisions for depreciation and amortization of fixed and intangible assets has been discussed in Chapters 13 and 14; charges to income should be reconciled with the amounts added to the related allowance accounts or credited directly to the respective asset accounts. The auditor should review and make a test examination of charges to maintenance and repair accounts to determine whether they include items which should have been capitalized. He will be concerned with the possibility that items which should be charged to maintenance and repairs may have been capitalized; his examination of additions to fixed assets should satisfy him on that point.

Insurance.—Insurance expense may represent the absorption of items originally charged to prepaid insurance, or amounts charged directly to expense as accrued or paid. The first are examined in conjunction with the examination of prepaid accounts; the second, in conjunction with the examination of accrued accounts or by examination of vouchers. Sometimes insurance expense can be reconciled with actual payments during the period adjusted by opening and closing balances in prepaid and accrued accounts. This is only rarely possible, but it is desirable if the accounting procedures permit it.

Rents and Royalties.—Rents and royalties can usually be substantiated relatively easily by reference to the respective lease and license agreements. Provision should be made for royalties on completed production but which may not be payable until subsequent reporting periods.

Traveling and Entertainment.—It may be advisable to examine the charges to travel and entertainment in some detail for a limited

period and to review this account for a more extensive period, as it is apt to become a dumping ground for doubtful charges and controls and authorizations over these expenses are not always of the best. Inquiry or tests should be made to ascertain whether all expense accounts have been submitted for the period under review.

Salesmen's Commissions.—The auditor may make a test examination of salesmen's contracts and ascertain that their provisions are properly reflected in the expense accounts. He should note whether commissions are payable upon shipment of goods or upon collection of accounts, upon gross or net sales, or after reduction for returned sales. He should ascertain whether commissions earned have been properly accrued.

Compensation of Officers.—Compensation of officers, whether in the form of salary, bonus, or a share of profits, should be checked to authorizations of the Board of Directors or the Executive Committee. If any part of the compensation is based upon a computation, such as a percentage of profits, it is usually incumbent upon the auditor to verify the calculation.

Donations.—If donations are material, this account should be analyzed and substantial items vouched. If large donations are authorized by the Board of Directors, as they frequently are, amounts donated should be checked to donations authorized in minutes of the Board of Directors.

Legal.—This account is customarily analyzed and the major items vouched, since it may contain changes not purely legal in character or may give the auditor clues to unrecorded liabilities.

Miscellaneous.—This account is usually scanned or analyzed since it may contain items which are properly chargeable to other accounts.

Taxes.—The auditor's examination of tax expense may be made in conjunction with his analyses of prepaid and accrued taxes.

Tax returns or tax bills are customarily examined in support of major items and computations of tax accruals are checked or test-checked by reference to data such as taxable income and taxable salaries and wages. Since the public accountant is usually skilled in income tax matters, he should be able to arrive at an intelligent opinion concerning this tax expense. The final determination of taxes depends upon government administration of the tax law as well as upon the law itself and exact determinations usually are not possible at the time of audit; however, it is usually possible to make

reasonable estimates of this liability. In the authors' experience, the tendency is too often to make inadequate provision for taxes.

Other Deductions.—Aside from cash discounts on sales, discussed above, other deductions usually consist of items which can be verified in detail or proved in total by the auditor, such as interest on funded debt, debt discount and expense, and losses on sales of fixed assets and securities.

Time of Examination.—Examination of the statement of income should be largely accomplished before the end of the accounting period. Review of internal control and partial analyses and detailed test examinations of operating accounts, as a practical matter, are better performed prior to the pressure of that work which must be delayed until the end of the accounting period.

STATEMENT PRESENTATION

General.—In Chapter 7, where the general form of the income statement was discussed, it was indicated that the usual and conventional presentation discloses the following as a minimum: sales or operating revenues; cost of sales or operating expenses; selling, general, and administrative expenses; other income; other deductions; income taxes; and net income. It was also brought out in Chapter 7 that, while it is customary to indicate the profit figures at the various steps or stages, such as gross profit following cost of sales, there has been some inclination towards the single step statement which places all items of income in one group and all costs and expenses in another group and subtracts the second from the first to arrive at the single figure of net income. Comparative income statements are strongly recommended by most accountants and analysts.

Since the purpose of the statement of income is to reveal to the reader in summary form the important financial characteristics of the results of operations it is frequently necessary to disclose not only additional details of the operating accounts, but also the bases upon which the accounts are kept. It is not possible to lay down specific rules for disclosure but, in general, consideration should be given to disclosure of material facts which would materially affect a reader's interpretation of the income statement. Information harmful to the enterprise and thus to the investor cannot always be disclosed, but it is sometimes difficult to determine whether failure to disclose results from management's desire to suppress bad news which should be revealed or from its hesitancy to divulge information which is legiti-

mately confidential. The content of the main captions in the conventional income statement and the basis upon which income is determined, particularly if unusual, may be material facts of interest to prospective purchasers or present holders of securities. While financial statements to be filed with the Securities and Exchange Commission must conform with certain requirements for disclosure, these requirements, like any set rules, sometimes hit or sometimes miss the statement presentation problems of specific companies. Without discussion of practice by the independent public accountant before the Commission, to which Chapter 22 is devoted, and without going into detailed requirements, the important thing to keep in mind is that disclosure, whether or not financial statements are to be filed with the Commission, should not necessarily be limited to what is ordinarily revealed by conventional financial statements, but should be considered in the light of what an intelligent investor would consider important.

Sales and Cost of Sales.—While some companies still do not publish the amounts of sales and cost of sales, but show gross profit as the first figure in the income statement, this practice is confined to a small minority. The argument usually advanced in favor of this practice is that disclosure of sales and cost of sales would be harmful in that it would provide competitors with helpful information. There is no doubt that there are sometimes real grounds for such a position, but there is also no doubt that the statement of income is less meaningful without disclosure of the gross volume of business.

It may be significant to disclose that sales are accounted for on an unusual basis such as on the percentage of completion under long-term contracts, or that a substantial portion is to one or a very few customers or to affiliates. Employment of the Lifo method of inventory valuation, or to state it from the income point of view, the matching of current revenues with current costs, or the employment of any unusual basis of costing sales, should be revealed and this is customarily indicated in a note common to both the income statement and balance sheet. Disclosure of the use of the Lifo method of valuing inventories may be of considerable importance to an investor because of the influence the method may have in the determination of present and future earnings. Cost of sales is sometimes broken down to indicate the larger components such as labor, material, and overhead. Sometimes both sales and costs of the principal major products are disclosed. Operating revenues and operating expenses of public utilities are customarily published according to the broad classifications prescribed by the regulatory bodies.

Depreciation and Amortization.—It is customary to disclose in the income statement the amount of depreciation of fixed assets provided for in the accounts during the period; amortization of intangible assets may be included with the depreciation of fixed assets and the respective amounts indicated parenthetically or in a footnote, or it may be a separate item in the income statement. The purpose of this practice is to reveal significant charges to operations which do not require the expenditure of cash. If significant, the depreciation or amortization policy should be stated.

Nonoperating Items.—Items of income arising outside the normal operations of the enterprise, such as dividends, interest, rents, royalties, and profits on sales of securities or fixed assets, should be segregated from operating income and the amount of each, if material, disclosed. Nonoperating charges, such as losses on sales of securities, fixed assets, and financial charges, such as interest should also be segregated and described. If nonoperating items are not significant in amount, they may be grouped—as Other Income and Other Charges or as the difference between the two.

If dividends from unconsolidated subsidiaries are substantial, or if the difference between dividends received by the parent and its equity in the subsidiaries' earnings is substantial, the amount of this difference should be disclosed. This principle of disclosure may be extended to a minority interest if the investment by the investing company is material in relation to its assets or if the income from the investment is material in relation to the investing company's total income.

Prior Period Adjustments.—Adjustments of income and expense of prior periods may be included with similar income and expense of the current period, or they may be segregated. The fact that they relate to operations of prior periods should be disclosed if the amounts are material. Some businesses have more difficulty than others in determining accurately those items of income and expense which must be estimated; if the accounts are subjected to continuous adjustments, it may be more logical to carry the adjustments to the accounts in which they would have been recorded if currently known, rather than to segregate them in one account.

Extraordinary Items.—It may be desirable to disclose the effect of extraordinary events upon current operations, but it is often difficult to distinguish the extraordinary from the ordinary. The temptation to regard charges to income as extraordinary, but credits to

income as ordinary should be resisted. Extraordinary items may be classified as other income or other deductions and should be so classified if they result from transactions outside the ordinary course of business.

Income Taxes.—Federal taxes on income should be stated in the income statement as a separate item. Except for usual recurrent differences between book and taxable income the amount of federal income taxes should be related to transactions included in the income statement, with appropriate disclosure of any material difference between income taxes payable and charged to current income and the amount which would have been payable based on reported income for the period. This matter was discussed earlier in the chapter and is set forth in Accounting Research Bulletin No. 23.

Reductions of income taxes resulting from the carrying forward or back of losses are properly reflected in the year in which such losses are availed of; the effect of such tax reduction, if material, should be disclosed. Many state taxes measured by income are technically franchise taxes; their amount is usually not material compared with federal income taxes and it is customary to include them with other costs and expenses.

Net Income.—As stated earlier in this chapter, all items resulting in profit and loss should be reflected in income except certain extraordinary items where inclusion would materially impair the significance of net income and which should be carried directly to earned surplus, as discussed in Chapter 7. Furthermore, reserves for contingencies, such as those for future declines in inventory prices, and provisions for depreciation based on replacement cost of fixed assets are regarded as appropriations of surplus having no effect upon net income.

Accountants are generally in agreement that net income should be designated clearly. Yet the deduction of income appropriations from net income, even though the appropriations are excluded from the determination of designated net income, in some instances has had an effect opposite from that intended. Accordingly, Accounting Research Bulletin No. 35, October, 1948, recommends "that the net income for the period be shown henceforth without deductions or additions of items which are properly excluded from the determination of net income," and that such items be carried directly to earned surplus.

Consistency.—The importance of consistency and comparability has been emphasized and discussed earlier in this chapter. When the

accounting methods or principles or their application are different from those of the prior period, the incomparability or inconsistency of the two statements, when material, should be indicated either in the body of the income statement or in a note accompanying it. If practicable, the dollar effect of the inconsistency or incomparability on the individual classification, on net income, or on both should be disclosed.

CHAPTER 21

CONSOLIDATED FINANCIAL STATEMENTS

Many corporations carry on some of their operations through subsidiaries. Subsidiary corporations may be formed, or the business of an acquired company may be continued under its previous corporate structure, because of legal or tax considerations, or because of operating or financial advantages. When a corporation controls other corporations through stock ownership, the question arises as how best to display its financial position and results of operations. Financial statements of a parent company alone are inadequate to disclose essential information if a substantial portion of the group's operations is conducted by subsidiary companies or if a substantial amount of assets is owned by these subsidiaries. On the other hand,

statements of the parent, plus separate statements of the subsidiary companies, may comprise so voluminous a mass of data and the relations of the companies may be so complex that intelligent summarization is necessary to make an understandable presentation of the financial picture. Consolidation of financial statements of a group of companies, designed to reflect pertinent data as they would appear if the companies were a single business entity, has been found to be the most useful method of summarizing the over-all financial information. The use of consolidated statements has become the common practice in stating the financial position and results of operations of a company and its subsidiaries.

ACCOUNTING PRINCIPLES

General.—Consolidated financial statements look through the form of corporate organization and present the financial position and results of operations of a consolidated group as they appear after elimination of intercompany transactions. The objective is to present the financial statements of the group as they would appear if they were those of a single company operating through divisions or branches rather than through subsidiary companies.

Definitions.—A consolidated balance sheet is one which sets forth all assets and liabilities of a parent company and such of its subsidiary companies as are included in the consolidation except accounts reflecting intercompany items which are eliminated in preparing the consolidated statement. It includes accounts receivable from and accounts payable to the public and capital stocks held outside the group, and states assets and surplus accounts on bases which would be appropriate if the parent company were the sole entity.

Similarly, a consolidated statement of income presents results of operations of a parent company and its consolidated subsidiaries after elimination of sales, costs, expenses, profits and losses arising from transactions between the consolidated companies.

In general accounting terminology, the word "subsidiary" means a company, the majority of whose voting capital stock is controlled by another company, usually referred to as the parent company. An affiliate is one of a group of related companies all of which are under common ownership or control. Sometimes the word "associated" is used to designate companies which are closely connected through operating or other contractual arrangements, but where control is absent.

Supplementary Data for Consolidated Statements.—Consolidated financial statements do not always furnish all the data which may be desired by shareholders, creditors, and financial analysts. Separate statements for the parent company may be required by creditors if a loan has been or is to be made to the parent, although if all the subsidiaries are in effect operating divisions, the parent's control may be such that its statement of income is not of great significance. If the parent company's earned surplus is small, and the retained earnings of the subsidiaries have been invested in fixed assets or necessary working capital, the separate position of the parent should be of interest to its stockholders. Minority stockholders in a subsidiary cannot derive information as to the position of the subsidiary from consolidated statements, and are interested in the statements of the subsidiary of which they are a stockholder. Bankers frequently wish to see individual statements of the subsidiaries in addition to the parent company and consolidated statements, as the status of bondholders and other creditors and the assets against which their claims rank may be shown clearly only by such individual statements. The consolidated working capital may be represented largely by that of subsidiary companies, and this may be important when the parent company has issued bonds requiring the maintenance of an agreed amount of working capital.

The purposes of presenting both the consolidated and the individual company positions and the results of operations may be accomplished by an analytical statement in which columns are provided for each company and for the consolidated figures. Subsidiaries which have common characteristics, as, for example, those operating domestically and those in foreign countries, those organized for manufacturing and those for distribution, may be grouped in these analytical presentations.

It is sometimes feasible to disclose supplementary information necessary to the proper understanding of consolidated financial statements by footnotes, rather than by the more cumbersome analytical statement in columnar form described above. For example, it is not unusual to indicate by footnote the amount of net assets of foreign subsidiaries included in the consolidated net assets, especially if there is considered to be some risk that such assets may not be available to the parent in the usual course of business. The allocation of consolidated surplus, working capital, or other data, as between parent and subsidiary companies, if significant, also may be disclosed in this manner. The auditor should exercise his best judgment to devise and recommend methods of presentation that will give the reader infor-

mation necessary to the proper understanding of the consolidated financial statements.

Basis of Inclusion or Exclusion of Subsidiaries from Consolidation.—When the parent company owns 100 per cent of the voting stocks of its subsidiaries, and they are in effect operating divisions of the parent, there can rarely be a question but that consolidated financial statements provide the fairest means of presenting the position and results of operation of the consolidated group. In practice, there are many instances of less than 100 per cent ownership; usually at least 51 per cent ownership of voting stock is necessary for legal control, but the relationships between the companies or the character of their operations may be such that consolidation does not result in the fairest presentation, even though the parent has legal control.

Usually the burden of proof is on those who wish to omit a controlled subsidiary from the consolidated statements, and the auditor must determine that the reasons for a proposed omission are sound. It is never proper to omit only those subsidiaries whose financial position and operating results would detract from the showing of the consolidated statements. On the other hand there are often valid reasons for the omission of certain subsidiaries from a consolidated group.

Often the type of business of a particular subsidiary so differs from that of the group as a whole, that consolidation of its figures with those of the other companies would lead only to confusion or unnecessary complexity. Under these circumstances a fairer presentation results from showing in the consolidated balance sheet merely the investment in the subsidiary supplemented by its financial statements. Such a situation is found when an industrial company controls a bank or a utility whose principal business is serving the public. There is less reason to consolidate subsidiaries which do little intercompany business with the group as a whole, or which are independently managed for one reason or another, than subsidiaries closely integrated with the holding company's operations. Bond or stock indentures of the subsidiaries may place such restrictions on current assets or surplus that a consolidated statement including such subsidiaries would be misleading. A subsidiary about to be disposed of or over which control is being exercised only temporarily might be excluded from consolidated statements. It is frequently advisable to omit from consolidation foreign subsidiaries which may be subject to uncertain economic, financial, or political conditions.

A further reason which may dictate the exclusion of certain subsidiaries from the consolidation is that their fiscal years do not coincide with the period for which the consolidated statements are made. When the fiscal years of foreign or other subsidiaries forming a minor part of the whole enterprise close one or two months in advance of the fiscal year of the group generally, it is usually feasible to consolidate their statements with those of the rest of the group. The intercompany accounts with such subsidiaries on the books of the other companies must be scrutinized carefully for the interim period to determine if, after the termination of their fiscal years, any substantial changes are indicated in the condition of such subsidiaries which would require consideration in the consolidated statements.

Technique of Preparation of Consolidated Statements.—The method of construction of consolidated financial statements is explained in books dealing with accounting procedure. Usually it consists of preparing the statements in columnar form by companies, with additional columns for the combined total of the group, for elimination of intercompany accounts and transactions, and for the final consolidated figures. The preparation of the eliminating entries and the disposition of differences between amounts shown on parent and subsidiary books involve many questions of accounting principle which are dealt with in the succeeding paragraphs of this chapter.

Consolidated Balance Sheet.—

Intercompany Receivables and Payables.—All intercompany accounts within affiliated groups should be eliminated in the consolidated balance sheet. In an audit of a company and its subsidiaries, intercompany items may be found in the regular accounts receivable and accounts payable records, in addition to accounts between companies carried separately in the general ledger. Intercompany accounts may give clues to items of intercompany income, costs, and expenses which require elimination in the preparation of the consolidated income statement. If intercompany accounts are not in balance, the difference should be reconciled so that adjustment for transit items may be made, either in the accounts themselves or in consolidating them.

Common Stock and Surplus of Subsidiaries.—Capital stock of consolidated subsidiaries carried in the investment account of the parent company should be eliminated against the corresponding proportion of capital and of surplus of the subsidiaries at the respective

acquisition dates, in conformity with the principle that acquisition of a majority interest in a subsidiary's capital stock represents in effect purchase by the parent company of the underlying assets subject to the liabilities, preferred stock outstanding in the hands of the public, and minority interest, if any, in the common stock and surplus of the subsidiary.

Whatever difference there may be between the majority proportion of underlying net assets of the subsidiary at date of acquisition and the amount paid for common stock by the parent company and carried to its investment account, requires adjustment in the preparation of the consolidated balance sheet either through intangible or tangible fixed assets or through consolidated surplus or reserve accounts, depending on the circumstances.

Excess of Cost of Investment in Subsidiary over Book Amount of Its Net Assets.—The Committee on Accounting Procedure in Accounting Research Bulletin No. 24, issued in December, 1944, has stated that:

> There is a presumption, when the price paid for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at date of acquisition, that the parent company, in effect, placed a value greater than book value on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. If practicable there should be an allocation of such excess as between tangible and intangible property and any amount allocated to intangibles should be further allocated to determine a separate cost for each type . . . .

The auditor should urge that parent company officials analyze the underlying considerations in the acquisition of a subsidiary and by independent appraisal as at the time, determine what classes of assets are represented by the excess of purchase price over the net assets acquired as shown by the subsidiary's accounts. It may be found that the excess is represented by tangible assets, by intangibles such as trade names, patents, patent rights, or goodwill not on the books of the subsidiary or carried at an amount having no relationship to the amount paid therefor by the purchaser, by inventory, by a favorable long-term lease held by the subsidiary, etc. The auditor should satisfy himself by means of corroborative evidence that the allocation of excess cost is reasonable.

If the excess is determined to be allocable to specific assets, it is not in accordance with generally accepted accounting principles to write it off in total against consolidated surplus, any more than it

would be proper to write off a portion of the cost of any other asset where there has been no loss in usefulness or other evidence of decline in value. If the excess is determined to represent any type of intangible, such as goodwill, having no limited term of existence and as to which there is, at the time of acquisition, no indication of limited life, its disposition should follow the principles discussed in Chapter 14.

Excess of Book Amount of Net Assets of Subsidiary over Cost of Investment to Parent Company.—If the book amount of net assets of a subsidiary at date of acquisition is greater than the purchase price paid for the stock, an analysis of the transaction is required to determine the nature of this excess. It may be that certain assets of the subsidiary are overstated on its balance sheet, and the difference represents an amount to be deducted from tangible or intangible assets in consolidating the balance sheets. Under other circumstances the difference might appropriately be carried to a reserve in the consolidated balance sheet to provide for estimated shrinkage, estimated losses, or even costs of rehabilitation of the assets of the acquired subsidiary. In exceptional cases, the excess may represent a donated or paid-in surplus, depending upon the circumstances.

Subconsolidations.—When the stock of a company which owns one or more subsidiaries is acquired, the amount to be adjusted in consolidation should be computed first by consolidating the balance sheets of the purchased company with those of its subsidiaries to determine the consolidated net assets of this group, and then by comparing the amount of such consolidated net assets with the amount paid by the purchasing company. The considerations already discussed relating to the disposition of any excess of cost over underlying net assets, or vice versa, apply to the computation of the eliminations in the subconsolidation as well as to the elimination of the excess which may apply to the parent in relation to the subsidiary group.

Acquisitions at Various Dates.—If control of a subsidiary is acquired over a period of time by the acquisition of blocks of shares at various dates, the determination of the related net assets at dates of acquisition presents certain problems. If the stock has been acquired in numerous small lots during the course of a relatively short period, the practice is to group the purchases, and computations of the amounts to be eliminated are determined on the basis of the balance

sheets of the subsidiary at dates nearest to the focal dates of the groupings. There have been instances of a company holding a minority interest, say 25 per cent, in another company for a considerable period of time, and then acquiring an additional 50 per cent of the outstanding stock. The question arises whether the parent is then entitled to reflect in consolidated earned surplus the earned surplus of the subsidiary applicable to the original 25 per cent during the period prior to the date when the control of the company was acquired.

The authors believe that as a general rule all acquisitions of the subsidiary's stock through the date when a controlling interest has been accumulated should be considered together and their aggregate cost compared with the related net assets of the subsidiary at that date. For subsequent additions, a separate elimination should be made for each purchase of stock against the proportionate share of the subsidiary's net assets calculated as applicable thereto at each date of acquisition. There may be exceptions to this rule depending on the length of the period during which acquisitions were made, on whether and to what extent dividends were paid, or on other considerations, so that sometimes it may be appropriate to include in consolidated earned surplus earnings of a subsidiary applicable to stock held prior to acquisition of a majority of its capital stock.

Addition to Investment Through Subscription to Capital Stock of Subsidiaries.—When additional capital stock is issued for cash by a subsidiary to majority and minority interests in ratable proportion, no change occurs in the percentage of minority interest or in the difference between the amounts of parent company investment and related net assets of the subsidiary. If the majority interest subscribes to more or less than its ratable proportion the computation of the difference will be affected because of the change in the percentage of ownership in the surplus.

If there are subholding companies in the consolidated group with minority interests, transfers of stocks of subsidiaries between subholding companies may also affect the aggregate difference between cost of subsidiaries' stocks to subholding companies and net assets at acquisition because of the change in relationship of interests.

Subsequent Changes in Net Assets at Acquisition.—The determination of the amount of net assets of a company at the date of the acquisition of its capital stock by another company involves the same difficulties encountered in the preparation of a statement of position at any date. The passage of time is frequently necessary to reveal

facts upon which proper accounts are stated. Allowances or reserves for deferred maintenance, for bad debt losses, or for contingent liabilities may be established as at the acquisition date, but such estimates are subject to adjustment when the facts later become known. Such adjustments will affect the net assets of the subsidiary at date of acquisition, and consequently appear in the consolidated financial statements as adjustments of the accounts in which the difference between cost and net assets is reflected. Any adjustment of net assets should be definitely related to the position at the acquisition date, and it is customary to adhere rather strictly to the rule of materiality. Adjustments should be made only if substantial, and the various accounts at date of acquisition should not be held open for an indefinite period.

Elimination of Other Intercompany Holdings of Securities.—Unless they are held in some special fund or under other restrictions, bonds and notes of affiliated companies owned within the consolidation should ordinarily be eliminated from the asset and liability side of the balance sheet, thereby showing as net liabilities only those owing to the public. Elimination will ordinarily involve adjustment of unamortized debt discount or premium balances relating to the intercompany securities and of consolidated income or earned surplus. In some instances the discount at which obligations of affiliated companies have been acquired has been included in contingent or other reserves in the consolidated statement.

Capital stock of the parent company held by subsidiaries should be reflected in the consolidated balance sheet as stock in treasury, and any dividends thereon received by the subsidiaries should be eliminated against the surplus charge therefor made by the parent.

Inventories.—Any material amounts of intercompany profits in inventories arising from purchases from affiliated companies at prices in excess of the actual costs of the selling companies should be eliminated from the inventory amounts in the consolidated balance sheet. This treatment is based on the well-established theory that, treating the group as a whole, a profit is not realized until the products which are manufactured or traded in have been sold to customers outside the group. Frequently provision for the elimination of such intercompany profits in inventories is made by setting up an allowance therefor on the books of the parent company.

Some questions arise as to what eliminations shall be made where there is a minority interest in a subsidiary. The minority interest

is entitled to the benefit of its share of profits earned by the subsidiary company regardless of the company's affiliations. Should only the portion of intercompany profit in consolidated inventories which is applicable to the majority interest be eliminated from the assets, or should the entire intercompany profit in inventories be eliminated? While there may be theoretical arguments for following the first method, it is better practice to exclude all intercompany profit from inventories remaining on hand so that the consolidated balance sheet will consistently reflect the principle of not taking up profits until goods have been sold outside the consolidated group.

When the entire intercompany profit is eliminated with respect to goods sold within the group by a constituent company in which there is a minority stock interest outstanding, the authors believe that the portion of such elimination which applies to the minority interest should be deducted from the minority interest stated in the consolidated balance sheet. This method states the minority interest in surplus at the amount of the minority's equity in the net assets as reflected in the consolidated balance sheet. Some contend that all of such elimination should be borne by the parent and deducted from consolidated surplus, rather than any part being applied against the minority interest in the subsidiary company's surplus. The latter method states the minority interest in surplus at the amount of the minority's equity as shown on the books of the subsidiary.

When the inventories include items which were sold by one company to another company of a consolidated group before the parent company acquired control of the selling company's stock, no elimination should be made for intercompany profits. Profits realized by a subsidiary prior to the date of effective control are represented in the net assets of the company which in effect were purchased by the parent company.

Fixed Assets Sold at Profit Within the Group.—When fixed assets are sold at a profit by one company to another company of a consolidated group, the profit should generally be eliminated in order that the fixed assets of the group may be stated at actual cost to the consolidation. Such profits might, however, be segregated as a special classification of the consolidated surplus, which would be in effect a revaluation surplus for the consolidation. As the fixed assets are usually depreciated on the basis of cost to the respective companies, the elimination of profits therefrom might reasonably entail an adjustment of the allowance for depreciation in consolidation. Losses on fixed assets sold by one affiliated company to another would not

usually be restored in consolidation, the losses representing in effect write-downs of book amounts of the assets.

Consolidated Statement of Income.—

Elimination of Intercompany Items in the Statement of Income.—It is important that all intercompany items be eliminated from the various account classifications of the income statement in order that the results from operations may reflect only transactions with the public. Intercompany sales and the cost of sales to the recipient of the goods should be eliminated, respectively, from consolidated gross sales and cost of sales, and any material amount of intercompany profit in inventories remaining unsold to the public at the beginning and end of the year should be determined and eliminated from computation of cost of sales. Other intercompany items to be eliminated include interest charged by parent company on advances to subsidiaries, dividends on subsidiary stocks held by the parent, administration service charges and commissions.

Uniformity of Account Classification and Fiscal Period.—Care should be taken to see that the classification of operating accounts is comparable within the companies that are consolidated, a matter to be watched especially when preparing a consolidated statement of earnings of companies that only recently became affiliated. If classifications differ, effort should be made to prepare consolidated statements in condensed form.

The statements of income of all consolidated subsidiaries preferably should be for the same fiscal period as that of the holding company. This is not always possible. If for good reason the fiscal periods of the subsidiaries cannot be made uniform, the auditor may accept the unavoidable and use his best judgment in making adjustments, exclusions, and reservations. It is frequent practice to close the accounts of foreign subsidiaries a month or two earlier than those of the parent company in order that audited foreign figures may be available for review and consolidation when the parent's accounts are closed. Satisfactory consolidated statements can usually be prepared when minor subsidiaries close their books not more than two or three months in advance of the fiscal year of the consolidation. The Securities and Exchange Commission allows the accounts of a subsidiary under these circumstances to be consolidated, provided the difference in dates is not more than 93 days and certain explanations are given.

The accounts of a subsidiary, if available, or, in any event, the parent's account with the subsidiary covering the interim period should be reviewed by the auditor to see whether any transactions, other than in the ordinary course of business, have occurred which have a material effect on the consolidated statements.

Deduction of Earnings of Subsidiaries Applicable to Minority Interests.—The consolidated income statement should show the deductions for dividends on subsidiaries' preferred stocks in the hands of the public and for interest on their obligations, separately from charges on obligations of the parent company. The portion of subsidiary company earnings applicable to minority holdings of common shares should be deducted in the consolidated income statement before arriving at the consolidated net income applicable to stocks of the parent company.

A form of consolidated income statement is sometimes used which shows first the income of subsidiary companies, after intercompany eliminations, coming down to the amount of net income from subsidiaries applicable to parent company holdings, after which the parent company's income is added and its fixed charges deducted. This form is particularly useful when the parent is primarily a holding company and not an operating company, and it has been used principally with utility systems. It has the advantage of clearly segregating subsidiary company interest and dividend payments to the public from the parent company's fixed charges.

Deduction of Cumulative Preferred Dividends on Subsidiary Shares.—If the earnings of a subsidiary which has cumulative preferred shares outstanding in the hands of the public are insufficient to cover preferred dividend requirements and no dividend is paid, provision should be made for the accrued dividends by a charge against the consolidated income. Under such circumstances the subsidiary has to improve its annual earning power in future years sufficiently to make up the preferred dividend requirements before the common stock (owned primarily by the parent company) can share in earnings.

It has sometimes been argued that if the unpaid preferred dividends are not guaranteed by the parent company, there is no more need to make a charge therefor in the consolidated income statement than to make a provision for unpaid cumulative preferred dividends in the income statement for a single company. This argument overlooks the fact that the charge in the consolidated income statement is not required because of any obligation on the part of the parent

company to pay such preferred dividends, but because they represent the accrual of a claim ahead of the common stock owned by the parent company and therefore an accruing loss through diminution of the value of its investment in such common stock. This loss must be recognized and allowed for in the consolidated income statement.

Deduction of Subsidiaries' Losses by Parent Company.—If a subsidiary has net income, the amount included in consolidated net income is that which remains after allocation of the proper portion thereof to the equity of minority stockholders.

If the subsidiary's capital has been wiped out by deficits and the subsidiary is operating at a loss, it may as well be recognized that the parent company will eventually assume all the losses, since minority holders cannot ordinarily be expected to advance their share of funds necessary to take care of the deficits. It will usually be found that the parent company must make cash or other advances in order that the subsidiary may remain in business. The parent company may carry as assets advances made to absorb the deficits of subsidiaries, but the auditor should not approve the full amounts of such items as assets in the parent company balance sheet unless collection of these advances appears probable. If collection of the minority share of the advances does not appear probable, the subsidiary's loss for the period should be deducted in its entirety in determining consolidated net income.

Depreciation, Depletion, or Amortization of Excess of Cost over Net Assets.—The provision for depreciation for a consolidated group of companies, as for a single company, must be based on a plan for extinguishing the cost of the depreciable assets over the periods of their estimated useful lives. While each company of the group may have provided proper allowances for depreciation based on its cost or book amounts, the parent company at date of acquisition may have paid more or less than the book amount of the subsidiary's stock, which excess or deficiency may be assignable to depreciable assets. Allowances for depreciation made by the individual companies may require adjustment by a consolidating entry in order to reflect proper allowances based on cost to the consolidation. A similar adjustment of depletion may be required in consolidation if it is determined that the variation from cost is assignable to properties which are subject to depletion.

If it is determined that an excess cost is properly assignable to intangible assets, the amortization of such excess should follow the rules discussed in Chapter 14.

Provision for Federal Income Taxes.—A parent company and such subsidiaries as are not less than 95 per cent owned are permitted under the tax law in effect in 1948 to file federal income tax returns on a consolidated basis on payment of normal tax and surtax at the combined rate of 40 per cent instead of the individual company rate of 38 per cent. This procedure may be advantageous under certain conditions, as for example when one or more subsidiaries have net losses. When consolidated returns are filed, the problem of allocation of the tax to the individual companies arises. Usually this is done on the basis of the ratio of normal tax and surtax of each company which would have been paid on a separate return basis to the aggregate amount of such taxes for the companies in the consolidation. This method is sanctioned by the Securities and Exchange Commission for purposes of the Holding Company Act. The Treasury has ruled that, for the purpose of determining earnings and profits of each member of an affiliated group available for dividends, consolidated income tax should be apportioned among members of the group in accordance with the ratio of that portion of consolidated normal-tax net income attributable to each member of the affiliated group to consolidated normal-tax net income, leaving out of consideration any member of the group having no net income. It is not good practice to assign to each subsidiary a portion of the consolidated tax equal to the tax of the subsidiary on an individual company basis, and to allocate the remainder to the parent company.

Even though all companies included in a consolidated return show taxable income, the tax which would be payable on intercompany dividends if individual company returns were filed might be higher than the 2 per cent "penalty" for filing consolidated returns. Therefore a parent company might absorb this 2 per cent as representing the cost of avoiding the tax it would otherwise pay on intercompany dividends received by it. There may be other instances in which equity would require other means of apportionment of consolidated tax to the companies included in the consolidated return; for example, the provisions of the Internal Revenue Code as to the carrying forward and back of losses might apply to one or more members of the group.

Income Taxes on Undistributed Earnings of Subsidiaries.—Earnings of foreign and domestic subsidiaries become available to the parent company for distribution to its stockholders only when they are paid to the parent company in the form of dividends. The dividends so paid are factors in the determination of federal income

taxes (and in some cases of state taxes) payable by the parent company, except in the case of dividends from domestic subsidiaries when consolidated returns are filed. Foreign dividends may be subject to foreign dividend taxes withheld at the source, and the parent company is entitled to a credit for such taxes and also for foreign taxes paid on earnings of foreign subsidiaries under certain conditions. The question arises whether provision for payment of federal income taxes on undistributed earnings of subsidiaries should be made currently by the parent company with respect to such earnings included in the consolidated income statements and accumulated in the earned surplus shown on the consolidated balance sheet. Assessment of such taxes may be long deferred, because it will be made only at the time dividends are declared and paid by the subsidiaries, and it is impossible to predict what rates will be in effect at that time. As to domestic subsidiaries, the parent company under present law pays tax on dividends received at an effective rate of 5.7 per cent, but if the subsidiary is included in a consolidated tax return, no tax is imposed on intercompany dividends; the tax on dividends received from foreign subsidiaries is reduced by the credit for foreign taxes paid by such subsidiary, so that the net tax to be paid cannot be predicted.

For these reasons, it is not customary to provide a reserve on the books of the parent company for possible taxes to be paid in the future on undistributed earnings of subsidiaries. A notation is sometimes made, if the circumstances indicate its desirability, to the effect that such undistributed earnings are subject to federal income tax when and if they are distributed to the parent company, at rates in effect at the time of distribution, and sometimes the approximate amount of such tax is given, computed at current rates.

STATEMENT PRESENTATION

When there are few companies included in the consolidated financial statements they may be named in the heading; this is not feasible when the number is large, but they are sometimes listed in the company's report to stockholders. Certain data which are frequently disclosed in consolidated financial statements are discussed below.

Minority Interests.—The accepted method of setting up the consolidated balance sheet is to include therein the entire assets and liabilities of the group (except for intercompany items eliminated) whether or not there be minority holders of subsidiary company

shares. Any such minority interests are represented on the credit side of the consolidated balance sheet by the amounts of their proportionate shares in the subsidiaries' net assets (capital and surplus) included in the consolidated statement. The minority interest in subsidiary company preferred shares should usually be stated separately from that in common shares. The amounts of such interest of outside stockholders are best placed on the consolidated balance sheet in a position between liabilities and capital.

Preferred Stock of Subsidiaries.—The amounts applicable to subsidiary company preferred stock not held by the parent company should be stated separately in the same section of the consolidated balance sheet as that in which the minority interests in subsidiary common stock and surplus appear, rather than grouped with the parent company's capitalization.

Preferred stock of a subsidiary held by the public is generally shown in the consolidated balance sheet at its par or capital amount as reflected in the books of the subsidiary plus any share it may have in the subsidiary company's surplus. If the subsidiary has a deficit, no part thereof may generally be attributable to the preferred stock, all being applicable as a reduction of the equity of the common stock, so long as the amount of the latter is sufficient. If the call or involuntary liquidation price of the subsidiary's preferred stock is in excess of that at which the stock is stated on the subsidiary's balance sheet, these prices should be indicated on the consolidated balance sheet. If material, the excess of aggregate involuntary liquidation price over aggregate par or stated value should also be indicated. If the equity in a subsidiary company's common stock has been wiped out through losses, the total equity in a subsidiary is vested in its outstanding preferred stock held by the public. If, however, the parent company also has a substantial creditor position with respect to such subsidiary, consolidation may nevertheless best display the facts.

The equity of the preferred stock in surplus of a subsidiary company is determined in accordance with the provisions of the indenture or articles of incorporation. In general, a noncumulative nonparticipating preferred stock may have no claim on surplus unless and until its dividend is declared or in connection with its redemption or liquidation. Accordingly, no part of the subsidiary surplus would be allocated to this type of stock in consolidation.

Cumulative preferred stock of a subsidiary company has an equitable claim on that company's surplus to be reflected in consoli-

dated financial statements to the extent of accrued and accumulated unpaid dividends.

The usual procedure is to add the amount of unpaid cumulative dividends to the aggregate interest of outside preferred shareholders appearing on the credit side of the consolidated balance sheet and, where the subsidiary's common stock is fully owned by the parent company, to reflect the accumulating diminution of the parent's equity by current charges against consolidated income as the arrears of preferred dividends accrue. If there is a minority common stock interest outstanding, a proportionate share of such arrears of preferred dividends is chargeable thereagainst until such minority interest is extinguished.

When there is a cumulative participating preferred issue of a subsidiary, its surplus should be allocated (1) to preferred stock for unpaid cumulative dividends, (2) to common stock for the maximum dividend it could receive before the preferred shares begin to participate, and (3) the balance between preferred and common stocks according to the stated basis of participation. To noncumulative participating preferred stock should be allocated the amount of surplus to which its participating feature entitles it, despite the fact that unpaid dividends on such stock do not accumulate. In each case the guiding principle should be to allocate to nonparent-owned participating preferred stock any portion of the subsidiary surplus which it is clear can be distributed only to such stock, either currently or in liquidation. In the event of there being a contingency of distribution to the participating preferred stock, which cannot at the time be expressed in definite amount, an appropriate note may be made in both consolidated balance sheet and income statement.

Unconsolidated Subsidiaries.—It has been noted that there may be good reasons for excluding a subsidiary of which a majority of the voting stock is owned by the parent company from the consolidation. When this is done, certain questions arise as to proper presentation of information regarding such unconsolidated subsidiary in the consolidated financial statements of the group.

INVESTMENTS IN AND EARNINGS OF UNCONSOLIDATED SUBSIDIARIES.—The capital stocks and obligations of unconsolidated subsidiaries owned by the parent or other subsidiary companies ordinarily are carried in the consolidated balance sheet at cost. Chapter 14 includes a discussion of accounting principles and statement presentation of these long-term investments. The consolidated balance sheet usually includes a footnote or is accompanied by a supple-

mental statement indicating net assets of unconsolidated subsidiaries applicable to these investments, particularly if the subsidiaries are foreign or if the parent's investment is a substantial portion of its assets. It is accepted practice to indicate, usually by footnote, the difference between dividends received by the parent company and the related earnings of the unconsolidated subsidiary during the period.

Changes in Subsidiaries Consolidated.—If, for proper reason, subsidiaries included in consolidated statements are not the same from one accounting period to the next, this fact should be disclosed in a note to the financial statements (see Chapter 6).

Guaranties of Subsidiaries' Obligations.—Holding companies may guarantee specific dividends or interest on capital stock or obligations of subsidiaries in the hands of the public or they may guarantee leases or other contractual obligations of a subsidiary. If dividends or interest are in arrears, the liability should be taken up on the consolidated balance sheet and, if material, the existence of the continuing obligation should be disclosed.

Mortgage of Subsidiary Not Guaranteed by Parent Company.—By contrast, there sometimes arises a question as to balance sheet presentation when there is a mortgage on real estate of a subsidiary not guaranteed by the parent company. Should the circumstances make it desirable to do so, the description of the liability may include the statement that it has not been guaranteed by the parent company.

Hypothecation of Capital Stock of a Subsidiary.—When capital stock of a subsidiary is pledged as collateral to bond or note issues of a parent, the description of the liability for these bonds or notes in the consolidated balance sheet should indicate that a subsidiary's stock is pledged thereagainst, since the pledge of stock is equivalent to an indirect pledge of assets of the subsidiary.

Availability of Surplus for Distribution.—The surplus of a subsidiary at the date of acquisition of its capital stock by its parent becomes acquisition surplus and is eliminated in the consolidated balance sheet. Dividends may be declared from this surplus by the subsidiary, but the portion of these dividends received by the parent company represents a reduction of its investment, and not income. If consolidated surplus is made up largely of surplus of subsidiaries earned since acquisition, it still may not be available for payment of dividends by the parent company. Bond indentures and preferred

stock provisions of the subsidiaries may restrict payments of dividends by them. If restrictions are such that notation is required on the balance sheets of the subsidiaries, they should be repeated on the consolidated balance sheet which includes these subsidiaries, unless they are not material in relation to consolidated surplus. Any other limitations upon the availability of consolidated surplus for distribution should be indicated on the consolidated financial statements.

Translation of Financial Statements of Foreign Subsidiaries and Branches.—In consolidating the financial statements of foreign subsidiaries or combining those of branches with statements of the parent and domestic subsidiaries, the accounts kept in foreign currencies must be translated into equivalent United States dollars. This was not difficult when exchange rates established in a free market were relatively stable, and goods and funds flowed between countries without undue restriction. Under present conditions, however, rates of exchange are established in a free market only to a limited extent, and official rates may not be available for many types of transactions, and in fact may vary considerably depending upon the type of transaction for which funds are intended to be used. Most countries have severely restricted the movement of funds out of their jurisdiction. Under these circumstances, it frequently appears that the consolidation of foreign subsidiaries is not the best way of showing the position of the parent company and its subsidiary companies.

However, circumstances with respect to certain countries are such that it still may be appropriate to consolidate the accounts of subsidiaries located therein with those of the parent company. There are some generally accepted accounting principles which apply to the translation of foreign currencies into United States dollars for such purpose, which are equally applicable to a branch or to a subsidiary.

Rates Appropriate for Translation of Foreign Currencies.—The basis used for translating assets, liabilities, and income of foreign subsidiaries stated in foreign currencies into their United States dollar equivalents may vary under different circumstances. The rules given below are generally applicable to most companies. Current assets and current liabilities except for accounts kept on a United States dollar basis by the subsidiary, are usually translated at rates in effect at the balance sheet date. When both official and free rates are in effect, the rate most appropriate to the circumstances should be selected. In general, the rates at which funds in payment of dividends or on open account are received by the parent, or the rates at which

the parent buys foreign currency for transmission to its affiliate should be considered in making the decision. Special problems sometimes arise in translation of inventories in foreign countries, for example when manufactured from materials furnished by the parent company and the process of manufacture is extended. Here the procedure sometimes applied is to use the lowest of the effective rates at date of purchase, the average monthly rate over the period of acquisition or manufacture, or the quoted rate at the balance sheet date. Fixed assets in foreign countries should be translated into United States dollars at the rates prevailing when such assets were acquired or constructed, unless the properties were paid for by the parent in United States dollars, so that dollar cost can be obtained readily. Similar rules are applied to deferred assets and long-term investments.

Long-term liabilities are translated at rates in effect when the liabilities were created or, if the liabilities existed when the subsidiary was acquired, they are translated at rates in effect at date of acquisition. Capital stock at date of acquisition is translated at rates in effect at that date. The statement of long-term debt payable in United States dollars involves no translation.

With certain exceptions, the items in the statement of income are translated at the average rates of exchange in effect during the period. If the earnings have been largely distributed to the parent as dividends, the rates at which remittances of such dividends were made may be proper for use in translation of the income statement. Such items as depreciation, depletion, and amortization of intangibles or of deferred charges are translated at the rates in effect at the time of acquisition of the related asset. The surplus balance at the beginning of the period is as stated at the opening balance sheet date, and the closing surplus represents this balance plus or minus changes in surplus during the year, converted as described above.

Disposition of Profit or Loss on Translation of Foreign Currencies.—When the parent company receives remittances from its foreign subsidiary or branch in settlement of open account or as dividends on its investment in subsidiary capital stock, it may realize a profit or loss measured by the difference between the rate of exchange at which funds advanced or earned were converted and the rate in effect when the cash transfer was made. Such profits or losses are reflected in the parent company's income when realized.

Unrealized profits or losses on translation of foreign currencies result from the translation of the financial statements of a foreign

subsidiary to United States dollars preparatory to including them in consolidated financial statements. Since different rates are usually used in translating the various balance sheet and income accounts, correction by debit or credit is required to restore the balance of assets and liabilities in the consolidated statements. The rule usually followed is to charge the unrealized loss to consolidated income, but to credit an unrealized profit to a reserve for foreign exchange adjustments. An exception may be made if the credit arises from a recovery of the exchange rate from a previously written-down level, and such profit may properly be credited to income.

A reserve for foreign exchange losses is sometimes created on the parent company's books to reduce the intercompany receivable from a foreign subsidiary to an estimated realizable amount when the foreign exchange rate declines, and sometimes a reserve is provided on the parent company's books in an amount equal to the unrealized loss resulting from translation of foreign subsidiaries' or branches' financial statements as discussed above. Such reserve is proper in relation to the investment in a foreign branch; investments in foreign subsidiaries are subject to the rules for long-term investments discussed in Chapter 14.

CHAPTER 22

PROCEDURE UNDER THE FEDERAL SECURITIES ACTS

The Securities and Exchange Commission.

Statutes Administered by S.E.C.—The Securities and Exchange Commission (S.E.C.) is an agency of the United States Government and administers the following statutes:

Securities Act of 1933
Securities Exchange Act of 1934
Public Utility Holding Company Act of 1935
Trust Indenture Act of 1939
Investment Company Act of 1940
Investment Advisers Act of 1940

The Commission also has certain functions in court proceedings under the National Bankruptcy Act.

In this chapter consideration will be given only to the accountant's duties under the 1933 and 1934 Acts.

Organization of S.E.C.—At the time this is written the main office of the S.E.C. is located in Washington, D. C. It has regional offices in New York, Boston, Atlanta, Cleveland, Chicago, Fort Worth, Denver, San Francisco, and Seattle, and branch offices in Detroit, St. Louis, St. Paul, Tulsa, and Los Angeles.

The Commission consists of five members appointed by the President with the consent of the Senate. One member is elected annually to serve as chairman. The Commission employs a staff of lawyers, accountants, engineers, analysts, and others. The staff is organized into the following divisions and offices which are directly responsible to the Commission:

Office of the Secretary
Trial Examiners
Opinion Writing Office
Office of the General Counsel
Office of the Chief Accountant
Corporation Finance Division
Trading and Exchange Division
Public Utilities Division
Administrative Division
Personnel Office
Budget and Fiscal Office
Regional Offices

The public accountant who has clients subject to the 1933 and 1934 Acts is concerned primarily with the workings of the Office of

the Chief Accountant, the Corporation Finance Division, and the Public Utilities Division.

The Chief Accountant is the principal adviser to the Commission on all matters relating to accounting and auditing and supervises the execution of S.E.C. policy in these fields. He drafts rules and regulations governing the form and content of financial statements filed with the S.E.C. and issues opinions on accounting questions of general interest.

The Corporation Finance Division has duties in connection with most of the statutes administered by the S.E.C. A director supervises the work of the Division, and he is assisted by a number of examining "sections," the Office of the Chief Counsel, and the Office of Assistant Chief Accountant. Each examining section is responsible to an Assistant Director of the Division and consists of a section chief, accountants, attorneys, and analysts.

The Office of Assistant Chief Accountant supervises the accounting work of the examining staff.

Questions of accounting involving the work of the Corporation Finance Division should be taken up first with that division. If exception is taken to a decision or opinion of that division, the question may be referred to the Office of the Chief Accountant and, if necessary, to the Commission.

Familiarity with S.E.C. Requirements.—Accountants undertaking examinations of financial statements filed under the 1933 and 1934 Acts should have knowledge of the requirements of the Acts and of the rules and regulations thereunder.

From time to time the rules and regulations are amended and new ones issued. Notices of new and amending rules and regulations and other information are given in releases. The S.E.C. from time to time also publishes opinions (in the form of releases) of its Chief Accountant relating to major accounting questions and to administrative policy with respect to financial statements. Accountants should familiarize themselves with these releases which are published as the Accounting Series. They may be obtained by writing to the Commission and asking to be put on the mailing list for them.

The accountant who participates in a registration engagement is charged not only with a knowledge of the Commission's formal requirements but also with its pronouncements on accounting matters. In 1938 the Commission issued, in Accounting Series Release No. 4,

the following statement of its administrative policy with respect to financial statements:

> In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant.

Under the 1933 Act the S.E.C. is empowered under certain conditions to declare the registration statement effective at a date earlier than the usual 20 days after the date of filing. To issuers and underwriters desiring to have a registration statement become effective at the earliest possible date, it is important that the registration statement as originally filed be free from errors of omission or noncompliance. This is further reason why public accountants should be thoroughly familiar with the requirements of Regulation S-X and with the applicable form and instruction book, all of which are published in the loose-leaf services or may be obtained from the S.E.C.

Independence of Certifying Public Accountants.—In recognition of its functions under the statutes which it administers, the S.E.C. has emphasized in several of its decisions and regulations the importance of complete independence on the part of public accountants who practice before the Commission. In Regulation S-X, for example, the Commission ruled as follows:

> RULE 2.01 Qualifications of Accountants.
>
> (a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

(c) In determining whether an accountant is in fact independent with respect to a particular registrant, the Commission will give appropriate consideration to all relevant circumstances including evidence bearing on all relationships between the accountant and that registrant, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

The S.E.C. is in a strong position to enforce its views respecting the qualifications of accountants who certify financial statements for filing with the Commission. Under Rule II(e) of its Rules of Practice:

The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

(1) Not to possess the requisite qualifications to represent others; or

(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

In elaboration of the term "substantial interest" quoted above, certain rulings of the Commission are of interest. The Commission has ruled that a firm of public accountants, one member of which owned stock in a corporation contemplating registration, was not independent for the purpose of certifying the financial statements of such corporation and based its decision on the fact that the value of such stock holdings was substantial and constituted more than 1 per cent of the partner's personal fortune (Accounting Series Release No. 2).

The Commission also stated its opinion concerning the independence of public accountants who have indemnity agreements with registrants. The question arose in connection with financial statements filed with the Commission where the registrant had agreed to indemnify the certifying accountant from all losses and liabilities arising out of his certification to which the accountant might become subject under the 1933 Act or at common law, other than for willful misstatements or omissions. The Commission took the position that

the existence of such an agreement removes or greatly weakens one of the major stimuli to objective and unbiased considerations of the problems encountered in a particular auditing engagement (Accounting Series Release No. 22).

In addition to numerous formal rulings involving independence of public accountants, the Commission has made a number of informal rulings, and in 1944 published a compilation of 20 cases in which it was held that a certifying accountant was not independent with respect to a particular company. These cases appear in the Commission's Accounting Series Release No. 47; some of them follow:

4. An accountant had loaned $5,000 to a registrant. A business associate of the accountant had loaned an additional $15,000 to the registrant. These loans bore interest and were secured by a 2½ percent share in the net profits of the registrant. A son of the accountant was an officer of the registrant. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

5. An accountant had for some time endeavored to persuade a department store that was his client to add a new department to its business. The registrant finally agreed to set up the department provided the accountant would finance the cost thereof. The accountant advanced the necessary funds and the department proved successful. The new department contributed less than 5 percent of the total revenues of the registrant. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the registrant.

6. An accounting firm had rendered services to a registrant for which the registrant had not been able to pay. To guarantee payment of the account the registrant had pledged shares of its own stock. In addition it had given the accountants an option to purchase the pledged securities at the market price existing at the date the option was given. *Held,* the accounting firm could no longer be considered independent for the purpose of certifying the financial statements of the registrant.

10. A partner in an accounting firm had served on the board of directors of a registrant but had resigned from that position prior to the close of the most recent fiscal year. This accountant had not participated in any way in the accounting firm's audits of the registrant. *Held,* that the accounting firm could not be considered independent for the purpose of certifying financial statements of the registrant covering any period during which a partner of the accounting firm was a director of the registrant.

14. The board of directors of a registrant had established an "operating committee" in which had been vested all powers necessary and

appropriate to the supervision of the management of the business. It was intended that the principal duty of the committee would be the making of recommendations to the board of directors. The committee consisted of two members of the board of directors and a member of the accounting firm that regularly certified the financial statements of the registrant. *Held,* neither the individual accountant nor his firm could be considered independent for the purpose of certifying the financial statements of the registrant.

16. An individual serving as assistant treasurer and chief accountant of a registrant was the son of a partner in the accounting firm that certified the financial statements of the registrant. The son was living with his father at the time. The son served the registrant under the direction and supervision of the treasurer of the company. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

17. A senior staff member of an accounting firm was appointed controller of a registrant as successor to a controller who had entered the armed forces of the United States during the war emergency. This employee, who had formerly been in charge of the audit of the registrant, remained on the staff of the accounting firm but relinquished all responsibility for the audit of the registrant, and did no work for the accounting firm in connection therewith. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant. *Held,* further, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant if the senior staff member were to leave the employ of the accounting firm and be paid by the registrant, but this arrangement were subject to the understanding among the several parties that upon the termination of the war emergency he would return to the staff of the accounting firm.

18. The accountant who audited the financial statements of an investment trust had been given office space in the office of the sponsor of the investment trust. The accountant regularly gave advice concerning the internal accounting policies of the trust. The sponsor of the trust had agreed to pay the accountant a stipulated amount per year less whatever the accountant was able to earn from the investment trust and his other clients. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the investment trust.

19. The accounting firm that certified the financial statements of a particular registrant had in the past followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the registrant's staff. These journal records were posted to the appropriate ledgers by the certifying

accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant that was not connected with the original recording of the accounting data. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant.

20. A small loan company kept its accounting records on a cash basis. The primary records of the company consisted of daily cash reports that were prepared by the cashier and signed by the manager. The accountant who certified the financial statements of this company took no part in the preparation of these basic records. However, he did audit these cash reports each month and then proceeded to enter the totals in a summary record which he in turn posted to the general ledger. The certifying accountant also made adjusting journal entries each month with respect to insurance, taxes, depreciation, and similar items. The company was small and did not require the services of a full-time bookkeeper. The certifying accountant devoted about one day a month to the clerical or bookkeeping tasks described above. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.

Regulation S-X.—This is the principal accounting regulation of the S.E.C. in its administration of the Securities Act of 1933 and the Securities Exchange Act of 1934 and no public accountant should attempt an examination under these Acts without having a copy at hand. Regulation S-X relates generally to the form and content of financial statements and supporting schedules required in most of the registration statements and reports under both acts. The regulation does not specify the dates or periods of financial statements; these requirements appear in the instructions accompanying the applicable registration statement or report forms. Regulation S-X also does not specify whether statements are to be furnished for the registrant, the registrant and its consolidated subsidiaries, the unconsolidated subsidiaries, and so on; these requirements also appear in the instructions of the applicable form. To illustrate, Form S-1 (applicable to the registration of securities under the 1933 Act) contains the instructions as to what statements are to be filed, the dates of the balance sheets, and the periods to be covered by the income statements, but Regulation S-X governs the form and content of these balance sheets and income statements.

Regulation S-X consists of a number of articles as follows:

1. Application of Regulation S-X
2. Certification
3. Rules of general application

4. Consolidated and combined statements
5. Commercial and industrial companies
5A. Commercial, industrial, and mining companies in the promotional, exploratory, or development stage
6. Management investment companies
6A. Unit investment trusts
7. Insurance companies other than life and title insurance companies
8. Committees issuing certificates of deposit
9. Bank holding companies and banks
10. Natural persons
11. Content of statements of surplus
12. Form and content of schedules

Articles 1, 2, 3, 4, 5, 11, and 12 would apply to most companies.

Each article, in turn, consists of a number of rules. Article 3 contains the rules of general application and consists of nineteen rules which are listed below in order to show their scope:

Form, order, and terminology
Inapplicable captions
Omission of inapplicable schedules and listings of such schedules
Omission of substantially identical notes
Omission of names of certain subsidiaries
Additional information
Changes in accounting principles and practices
Summary of accounting principles and practices
Conversion of items in foreign currencies
Opening balances
Valuation and qualifying reserves
Basis of determining amounts—book value
Items classed as current assets
Items classed as current liabilities
Treatment in balance sheet of reacquired evidences of indebtedness
Treatment in balance sheet of reacquired shares
Treatment in balance sheet of discount on capital shares
General notes to balance sheets:
    Assets subject to a lien
    Intercompany profits and losses
    Defaults
    Preferred shares
    Contingent liabilities

General notes to income statements:
- Installment or deferred sales
- Intercompany profits and losses
- Policy as to depreciation, depletion, and amortization of physical property and intangible assets and accounting for maintenance, repairs, renewals, and betterments

Article 4 contains the rules relating to consolidated and combined statements and consists of the following rules:

- Application of Article 4
- Consolidated statements of registrant and subsidiaries; principles to be followed
- Group statements of subsidiaries not consolidated; principles to be followed
- Statement as to principle of consolidation or combination followed
- Reconciliation of investment of parent in subsidiaries and its equity in their net assets
- Reconciliation of dividends received from, and earnings of, unconsolidated subsidiaries
- Showing of minority interests
- Statement required where intercompany items and transactions are not eliminated
- Special requirements as to:
  - Insurance companies
  - Bank holding companies
  - Banks
  - Public utility holding companies

The form of balance sheet for commercial and industrial companies is specified in Rule 5.02, the form of income statement of such companies in Rule 5.03, and the schedules to be filed for such companies are listed in Rule 5.04. The requirements as to the statement of surplus are contained in the instructions for the balance sheet.

The substance of Article 5 is not reprinted here; as previously stated—and it is worth repeating—a public accountant who participates in the preparation of a registration statement or report under the 1933 or 1934 Acts must have at hand a copy of Regulation S-X including all amendments.

To a public accountant who has conscientiously attempted to comply with all the instructions, it may come as a surprise that the S.E.C., after an examination of the financial statements he certifies,

suggests that additional information be furnished, usually in notes to the financial statements. But this should cause no astonishment: first, because the instructions in Regulation S-X represent minimum requirements, and second, because the S.E.C. has certain requirements which are applicable in many registrations but which, for some reason, it has not incorporated in Regulation S-X. For example, when there are material bonus and profit-sharing arrangements, the Commission insists that the provisions thereof be briefly stated in a note to the financial statements together with a disclosure of the amounts paid for each year covered by the income statement to (a) officers and directors, and (b) employees. Similarly, when there is a pension plan revocable by the company, the S.E.C. requires that a notation be made as to the company's unfunded actuarial reserve requirement for employees' services rendered prior to the adoption of the plan. At the time this is written, neither of these requirements appears in Regulation S-X, or in any other published rule of the Commission.

THE SECURITIES ACT OF 1933

Principal Provisions.—The Securities Act of 1933 is a *disclosure* statute, the disclosure being provided by means of a registration statement and a prospectus. Under the law the function of the S.E.C. is to see that there is available to the investor all information pertinent to the company's business and its securities as a basis for deciding whether to purchase its securities. The merits of any security are not reviewable by the S.E.C. The S.E.C.'s chief interest is in seeing that the facts with respect to the issuer of the security are truthfully told, and that no material information has been withheld. It is unlawful for any one to represent that, because a registration statement is in effect with respect to a security, the statement is true and correct on its face. On the first page of every prospectus there must be a legend to the effect that the securities have not been approved or disapproved by the Commission nor has it passed upon the accuracy or adequacy of the prospectus. The law also makes unlawful fraudulent practices in the sale of securities sold in interstate commerce.

A registration statement usually consists of two parts: a prospectus containing the most significant information about the issuer of the security, and certain additional information which is not deemed to be of primary importance. Although this additional information may be omitted from the prospectus, it must be included

in the registration document. The prospectus is also subject to the disclosure provisions of the law, and a copy must be delivered to each person to whom an offer is made.

Registration Procedure.—The law provides that a registration statement shall become effective twenty days after it has been filed with the S.E.C., but empowers the Commission to declare the statement effective at an earlier date when valid reasons exist. As previously noted, this acceleration provision is of importance to accountants as well as to other persons participating in a registration engagement.

After the registration statement has been examined by the Commission's staff, the S.E.C. issues a memorandum of comment (more commonly known as a "deficiency memo") suggesting changes in or additions to the material originally filed. At this point the Commission's suggestions are often discussed informally by representatives of the issuer and the Commission's staff. If the registration statement is not appropriately corrected by amendment, the Commission may exercise its "stop order" powers and refuse to allow the statement to become effective until it is amended.

Accountant's Liabilities Under the Act.—Under Section 11(a) of the Act:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . . may . . . . sue—
>
> . . . . every accountant . . . . who has with his consent been named as having . . . . certified any part of the registration statement . . . . with respect to the statement in such registration statement . . . . which purports to have been . . . . certified by him.

The section quoted above is significant to all persons connected with a registration engagement. To public accountants it is especially significant in that it makes it clear that the registration statement speaks *as of its effective date.* As discussed later in this chapter, this means that the need for diligence on the part of the public accountant does not end with the completion of his work in the field.

As stated above, the certifying accountant may be sued if he certifies false or inadequate financial statements in a registration statement. The law provides, however, that no person, other than the issuer, shall be liable who shall sustain the burden of proof that

> as regards any part of the registration statement purporting to be made upon his authority as an expert . . . . he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . . [Section 11(b)(3) of the Act.]

The standard of reasonableness referred to above shall be that required of a prudent man in the management of his own property [Section 11(c) of the Act].

Limitations of Actions to Recover.—Suit must be brought within *one year* after the discovery of the untrue statement or omission or after such discovery should have been made by exercise of reasonable diligence, and in any event within *three years* after the security was bona fide offered to the public (Section 13 of the Act).

No liability under the Securities Act shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission notwithstanding that such rule or regulation may thereafter be amended or rescinded or determined to be invalid (Section 19 of the Act).

Information Required in Registration Statement.—The law provides (Section 7) that a registration statement shall contain the information and shall be accompanied by the documents specified in Schedule A of the Act. The S.E.C. is empowered, however, by rules and regulations, to waive any such information or document in respect of any class of issuers or securities if it finds the requirement inapplicable and adequate disclosure is otherwise made. Under this authority the S.E.C. has devised numerous forms for registration of securities. The instructions accompanying each form make it clear in what situation it may be used. Any registration statement shall be deemed to be filed on the proper form unless objection to the form is made by the Commission prior to the effective date of the statement (Rule 401).

Registration Statement Forms.—A complete listing of all registration forms currently in use follows:

Form S-1 General form for registration of securities of issuers for which no other form is authorized or prescribed

Form S-2 For securities of nonsuccessor commercial and industrial corporations having no subsidiaries and still in the development stage

Form S-3	For shares of mining corporations in the promotional stage
Form S-4	For securities of closed-end management investment companies registered on Form N-8B-1
Form S-5	For securities of open-end management investment companies registered on Form N-8B-1
Form S-6	For securities of unit investment trusts registered on Form N-8B-2
Form S-7	For securities of international banking organizations
Form S-10	For oil or gas interests or rights
Form S-11	For shares of exploratory mining corporations
Form C-2	For certain types of certificates of interest in securities
Form C-3	For American certificates against foreign issues and for the underlying securities
Form D-1	For certificates of deposit (except those for which Form D-1A is specified)
Form D-1A	For certificates of deposit
Form F-1	For voting trust certificates

Before starting his work on a registration engagement, the public accountant should have available to him and should be familiar with a copy of the proper registration form as well as a copy of Regulation S-X.

Form S-1.—As will be apparent from the foregoing list, Form S-1 is a catch-all to be used where no other form is authorized or prescribed, and most business organizations use it in registering with the Commission.

A registration statement on Form S-1 consists of two parts: information required in the prospectus, and certain other information and documents which are not required in the prospectus. As used here the term "prospectus" means a general prospectus, as distinguished from a prospectus in the form of a newspaper advertisement.

The prospectus must contain among other things information as to the name of the issuer, a description of the business and the significant developments in the past five years, a description of the principal plants, mines, and other physical properties, a description of capital securities outstanding and being registered, names of underwriters and nature of the underwriting arrangements, names of directors and officers, the remuneration of certain persons, the provisions of material bonus and profit-sharing arrangements, and the nature of claims or charges involved in legal proceedings. Also required in the prospectus are the financial statements specified in the "Instructions as to Financial Statements."

The second part of the registration statement contains the exhibits, supporting schedules to financial statements, and other data which may be omitted from the prospectus. Included among the exhibits are copies of the charter, by-laws, certain franchises, indentures and contracts, an opinion of counsel as to legality of the securities being registered, a list of subsidiaries, certain historical financial information (Exhibit 17, see page 536), expenses of issue, and other information.

The accountant should read the entire registration statement (including the prospectus) to consider whether there are any statements therein not consistent with the financial statements and supplemental schedules he is expected to certify.

Financial Statements in Form S-1.—The public accountant will do well to consult the Instructions as to Financial Statements in Form S-1 at the beginning of an examination contemplating registration under the Securities Act of 1933. Not only do the instructions change occasionally, but they also contain some provisions which otherwise might be overlooked. For example, if the proceeds of the financing are to be used to purchase a going business, then financial statements of that business usually must be furnished.

The instructions as to financial statements specify the balance sheets and statements of income which are required to be filed as part of the registration statement on Form S-1. As to the form and content of those statements, certification by accountants, and the required supporting schedules, Regulation S-X governs. In other words, the instructions for Form S-1 specify the dates as of which and the periods for which the statements are to be furnished, but they do not indicate, for example, how inventories are to be shown in the balance sheets; on that point recourse must be had to Regulation S-X which specifies the information desired in respect of inventories—such as the basis at which carried and the breakdown into principal components.

The financial instructions may be classified as those relating to:

A. The registrant (that is, the issuer of the securities being registered)

B. The registrant and its subsidiaries consolidated

C. Unconsolidated subsidiaries and certain other "persons"

D. Special requirements
   (1) As to affiliates securing an issue being registered,
   (2) When there has been a reorganization or succession, and

(3) When a business has been acquired within one year or is to be acquired, by the registrant.

Statements of the Registrant.—A balance sheet of the registrant is required as of a date within 90 days prior to the date of filing, unless the following conditions exist, in which event the balance sheet may be as of a date within six months prior to the date of filing:

1. The registrant is not a bank, holding, or other finance company;
2. The registrant has at least one class of securities listed on an exchange;
3. The registrant's total assets, as shown by its most recent balance sheet filed, exceed $5,000,000;
4. No funded debt of the registrant is in default.

If the balance sheet complying with the above requirement is not certified, there shall be filed *in addition* a certified balance sheet within one year unless the registrant's latest fiscal year ended within 90 days prior to the filing date, in which case the certified balance sheet may be as of the close of the preceding fiscal year.

Statements of income and surplus of the registrant are required for each of the three fiscal years preceding the most recent balance sheet filed and for the period, if any, between the close of the most recent of such fiscal years and the date of the most recent balance sheet. These statements are to be certified through the date of the most recent certified balance sheet filed.

Under the following conditions the income (but not surplus) statement of the registrant may be omitted and a consolidated statement of income substituted:

1. The registrant is primarily an operating company; and
2. Each subsidiary included is "totally-held" (as defined in Regulation S-X, this is not synonymous with "wholly owned" as ordinarily understood); and
3. In addition to the balance sheet of the registrant, a balance sheet is filed which consolidates the registrant and subsidiaries included in the consolidated income statement.

All financial statements of the registrant may be omitted under the 85 per cent rule as discussed on page 518.

Consolidated Statements.—Where applicable, consolidated balance sheets of the registrant and its subsidiaries must ordinarily be

furnished as of the same date as the registrant's balance sheets referred to above. Special instructions are listed for registrations where it is not practicable to furnish the consolidated balance sheet as of the same date as the registrant's, but they are omitted here inasmuch as they are seldom used in practice. If the most recent consolidated balance sheet is not certified, then a certified consolidated balance sheet must also be submitted as of a date within one year unless the latest fiscal year of the registrant has ended within 90 days prior to the date of filing, in which case the certified consolidated balance sheet may be as of the end of the preceding fiscal year. If the certified consolidated balance sheet is not filed as of the same date as the certified balance sheet of the registrant, then there must also be submitted a certified balance sheet of the registrant as of the same date as the certified consolidated balance sheet.

Consolidated statements of income and surplus are required for each of the three fiscal years preceding the most recent consolidated balance sheet filed, and for the period, if any, between the close of the most recent of such years and the date of the most recent consolidated balance sheet filed. These statements must be certified through the date of the most recent certified consolidated balance sheet.

All consolidated financial statements of the registrant and its subsidiaries may be omitted under the 85 per cent rule as discussed on page 518.

Statements of Unconsolidated Subsidiaries.—For each majority-owned subsidiary of the registrant which is not consolidated, the same financial statements must be submitted which would be required if the subsidiary were itself a registrant, except as indicated in the paragraph following. Insofar as practicable, these financial statements must be as of the same dates and for same periods as those of the registrant. If there is more than one such unconsolidated subsidiary, their financial statements may be consolidated or combined in one or more groups pursuant to principles of inclusion or exclusion which clearly exhibit the financial condition and results of operation of the group or groups. If it is essential to a properly summarized presentation of the facts, the consolidated or combined statement is required to be filed. Special instructions are provided where it is not practicable to furnish balance sheets of unconsolidated subsidiaries within ninety days prior to the date of filing.

All financial statements of unconsolidated subsidiaries may be omitted if

(a) the aggregate assets of all subsidiaries and 50 per cent owned companies referred to below for which statements are so omitted do not exceed 15 per cent of the total assets of the parent and its consolidated subsidiaries as shown by the most recent consolidated balance sheet filed with the registration statement or, if none, by the most recent balance sheet of the parent so filed, *and*

(b) the aggregate revenues or sales of all such companies do not exceed 15 per cent of the aggregate revenues or sales of the parent and its consolidated subsidiaries as shown by the consolidated income statement filed with the registration statement, or, if none, by the income statements of the parent so filed.

50 Per Cent Owned Companies.—When the registrant owns, directly or indirectly, approximately 50 per cent of the voting securities of any company, and approximately 50 per cent of the voting securities is owned by another single interest, there is required to be filed for each such company the financial statements which would be required if it were a registrant, together with the identification of the other single interest, except that statements of 50 per cent owned companies may be omitted under circumstances such as those indicated above for unconsolidated subsidiaries.

Affiliates Whose Securities Secure an Issue Being Registered.—For each affiliate, securities of which constitute or are to constitute a substantial portion of the collateral securing any class of securities being registered under the Act, there shall be filed the financial statements that would be required if the affiliate were itself a registrant.

Reorganization or Succession.—Form S-1 contains detailed instructions as to financial statements required to be submitted when there has been a reorganization or succession. Statements are required to be furnished pursuant to such instructions if the following conditions exist:

(a) The registrant has been reorganized; or it has succeeded to one or more businesses in a single succession, or in a group of related successions, and its assets prior thereto were less than 50 per cent of its assets thereafter; *and*

(b) Income statements of the registrant are not filed for three full fiscal years of the registrant subsequent to reorganization or succession.

Because this situation is met only infrequently in practice, the required financial statements in the event of reorganization or succession are not detailed here.

Businesses Acquired or to Be Acquired.—Financial statements are required for any business directly or indirectly acquired within one year or to be directly or indirectly acquired by the registrant. The acquisition of securities constitutes the indirect acquisition of the business conducted by the person, the securities of which are acquired, if either of the following conditions exist:

1. The securities acquired give control of the company or, combined with securities previously held, will give such control.
2. The book value of the securities acquired as shown by the books of the issuer at the time of acquisition combined with the book value of securities of the issuer already held amounts to more than one-half of the net worth of the issuer; or, if evidences of indebtedness, are more than one-half of the sum of the net worth and outstanding funded debt of the issuer.

The balance sheet required must be as of a date reasonably close to the date of acquisition or, if not yet acquired, as of the same date as the most recent balance sheet filed for the registrant. This balance sheet need not be certified, but if it is not, there shall be filed in addition a certified balance sheet as of the close of the preceding fiscal year. Income and surplus statements must be furnished for each of the three fiscal years preceding the date of the most recent balance sheet filed and for the period, if any, between the close of the most recent of such fiscal years and the date of the balance sheet. These statements shall be certified through the date of the certified balance sheet. Special instructions apply if the business was or is in insolvency proceedings.

No financial statements need be furnished for:

(a) Any business acquired or to be acquired from a totally held subsidiary.

(b) Any business for which statements are otherwise required to be filed; or

(c) Any one or more businesses if:

(1) The aggregate assets of all businesses for which statements are so omitted do not exceed 15 per cent of the total assets of the registrant and its consolidated subsidiaries as shown by the most recent consolidated

balance sheet filed with the registration statement or, if none, by the most recent balance sheet of the registrant so filed, *and*

(2) The aggregate revenues or sales of all such businesses do not exceed 15 per cent of the aggregate revenues or sales of the registrant and its consolidated subsidiaries as shown by the consolidated income statements filed with the registration statement or, if none, by the income statements of the registrant so filed.

85 Per Cent Rule.—Notwithstanding the requirements of any of the instructions, the following financial statements may be entirely omitted from the registration statement:

(a) The consolidated financial statements of a person and its subsidiaries may be omitted if (1) its individual statements are included in the registration statement; (2) its total assets, exclusive of investments in and advances to the consolidated subsidiaries, constitute 85 per cent or more of the total assets as would be shown by the most recent consolidated balance sheet if filed for such person and its subsidiaries; and (3) its total gross revenue exclusive of interest and dividends received from the consolidated subsidiaries, constitute 85 per cent or more of the total gross revenue as would be shown by the consolidated income statements if filed for such person and its subsidiaries.

(b) The individual financial statements of a person may be omitted if (1) consolidated financial statements of such person and one or more of its subsidiaries are included in the registration statement; (2) its total assets, exclusive of investments in and advances to the consolidated subsidiaries, constitute 85 per cent or more of the total assets as shown by the most recent consolidated balance sheet filed for such person and such subsidiaries; and (3) its total gross revenue for the period for which its income statements would be filed, exclusive of interest and dividends received from such consolidated subsidiaries, constitute 85 per cent or more of the total gross revenue as shown by the consolidated income statements filed for such person and such subsidiaries.

Filing of Other Statements.—If the statements required by the instructions for Form S-1 are inadequate or inappropriate, the Commission may, upon the informal written request of the registrant, permit the omission of one or more of the required statements and the filing in substitution therefor of appropriate statements of

comparable character. The Commission may also by informal written notice require the filing of other statements in addition to, or in substitution for, the required statements when such statements are necessary for a proper presentation of the financial condition of any person for which financial statements are required, or for which such statements are otherwise necessary for the protection of investors.

Recasting of Previously Reported Accounts.—Surplus adjustments, material in amount, have occurred frequently in practice, and the public accountant may be concerned as to the treatment to be accorded these adjustments when they affect the income of any period included in the registration statement—either in the formal income statement or in the earnings summary. In the opinion of the authors, when such adjustments are material, the best practice is to restate the income accounts of prior years. Recasting may also be required in respect of reserves provided in prior years for costs or losses which were materially different from the provisions therefor, and for material adjustments of federal income taxes. Notwithstanding that this results in net income different from that previously reported, the guiding objective should be to make a fair presentation in the light of information obtained since the earlier statements were issued.

Prior Representations by the Issuer.—Insofar as he can reasonably do so, the public accountant should ascertain whether representations by the issuer in the registration statement are consistent with representations made elsewhere: for example, in annual reports to stockholders, in previous flotations, in Forms 10 or 10-K filed under the Securities Exchange Act, or in listing applications and reports filed with stock exchanges.

If the net income shown in a registration statement to be filed under the 1933 Act differs from the net income for the same period as previously reported by the company to its stockholders or to a national securities exchange, it is advisable for the issuer to append a note to the income statement in explanation of the difference. Any other material differences between financial statements in a Securities Act registration statement and those previously made publicly available should also be disclosed and explained in notes to the financial statements in the registration statement.

Earnings for Part of a Year.—When an income statement is submitted for an interim period of less than one year and there is reason to believe that the income and expenses for the interim period

may not be indicative of the rate of yearly earnings because of seasonal variations or for other reasons, it is essential that a footnote to that effect be appended. The need for this precautionary note should also be considered in connection with the summary of earnings in the narrative section of the prospectus.

Whether True Statements Are Not Misleading.—The public accountant's examination should enable him to form an opinion not only whether the individual items in the financial statements are fairly stated, but also whether the financial statements as a whole are true and not misleading. For example, a corporation, organized during World War II, had a phenomenal war production record, and, with a very small capital investment, realized substantial profits. After the war, the company was faced with serious problems in converting to peacetime production and in obtaining scarce materials because of the loss of wartime priorities. The owners of the company sold their stock to an underwriting group and began the preparation of a registration statement in anticipation of a public offering of the stock. The then auditors had not examined or certified the earnings of the war period, but it seemed to them, and they recommended, that the income statement should not be included in the prospectus since it covered the war period only. There was no pre-war earnings record, and, in the circumstances, the income statement could serve no useful purpose. The advice of others prevailed, however, and the prospectus as initially filed included the income statement with appropriate disclosures. The Commission in due course issued a memorandum of comment recommending that in the circumstances of this particular registration all statements setting forth operating results should be omitted from the prospectus and filed as an exhibit. The registration statement and prospectus were amended accordingly.

S.E.C. Requirements as to Certificates.—Most of the formal financial statements and supporting schedules included in a registration statement filed under the 1933 Act are required to be certified by independent public or independent certified public accountants. The Commission's requirements as to certification are contained in Rule 2.02 of Regulation S-X which follows:

Rule 2.02 Accountants' Certificates.

(a) Technical requirements.

The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) Representations as to the audit.

The accountant's certificate (i) shall contain a reasonably comprehensive statement as to the scope of the audit made including, if with respect to significant items in the financial statements any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission; (ii) shall state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances; and (iii) shall state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) Opinions to be expressed.

The accountant's certificate shall state clearly:

(i) the opinion of the accountant in respect of the financial statements covered by the certificates and the accounting principles and practices reflected therein;

(ii) the opinion of the accountant as to any changes in accounting principles or practices, or adjustments of the accounts, required to be set forth by Rule 3.07; and

(iii) the nature of, and the opinion of the accountant as to, any significant differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) Exceptions.

Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

Form of Certificate.—The standard short form of report or opinion (see Chapter 6) meets the Commission's requirements for

certification. The certificate, however, is also required to cover the supporting schedules. A simple method of accomplishing this result is by adding the words "and the supporting schedules" (or similar identification) to the first paragraph, dealing with the scope of the examination, and to the last paragraph, which contains the opinion.

This procedure is sometimes objected to by the investment bankers who underwrite the security being registered. Their objection stems from the fact that the supporting schedules (except supplementary profit and loss information) are not contained in the prospectus which is the document delivered to the investor, and if the accountant in his certificate refers to the supporting schedules, there is an implication that the schedules are essential to a showing of the position and results of operation of the enterprise. This objection has some merit and may be overcome by phrasing the opinion paragraph as follows:

> In our opinion, the accompanying financial statements (pages .... to ...., inclusive) present fairly the financial position of..Company at (date), and the results of its operations for the years ...., ..., and ...., and the supporting schedules present fairly the information required to be set forth therein, all in conformity with generally accepted accounting principles applied on a consistent basis.

Bankers or their counsel may also object to this form of opinion for the reason that it contains a reference to schedules which are not contained in the prospectus. When they do, it is desirable to issue two separate certificates—one covering the statements in the prospectus, and another covering the supporting schedules. The latter certificate will not appear in the prospectus, but will accompany the schedules to which it relates, and may take the following form:

> We have examined the balance sheet of........................ Company as of (date) and the related statements of income and surplus for the years 19—, 19—, and 19—, and the supporting schedules. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the supporting schedules (Exhibit ...., or pages .... to ...., inclusive, of the registration statement) present fairly the information required to be set forth therein, in conformity with generally accepted accounting principles applied on a consistent basis.

Most prospectuses contain so-called "earnings summaries" which have been reviewed by independent public accountants. The Commission's attitude in respect to such reviews is set forth in its Accounting Series Release No. 62 and quoted, in part, on page 525 of this volume. As indicated in that release, if the statement is made that an accountant reviewed the summary, then his report or opinion must be furnished. Suggestions as to the form of the accountant's report on the earnings summary appear on page 527.

Certificate When Part of Examination Is Made by Another Accountant.—Frequently a part of the examination of financial statements is made by public accountants other than the firm which signs the certificate covering such statements. The financial statements of a Canadian subsidiary of an American corporation, for example, may be examined by Canadian accountants. The Americant accountant certifying the consolidated statements may or may not, depending on circumstances, refer to the examination by other auditors. If the American accountant does so refer, his opinion will usually be "based upon our above outlined examination and the aforementioned report of Canadian chartered accountants . . . ." A certificate of this kind will not meet S.E.C. requirements unless there is also filed the certificate of the Canadian accountants. The S.E.C. takes the position that a signed certificate of the Canadian accountants should be filed or, in lieu thereof, the American accountants should assume the same responsibility for the audits of the other accountants as though the American accountants had made the examination. This seems an unreasonable position since, if the American firm could assume such a high degree of responsibility for work they had not performed, there would be no point in mentioning that part of the examination had been made by others. The American firm would probably assume no such responsibility, and the Canadian firm should certify somewhat as follows:

> We have examined the balance sheet of X Corporation as at (date) and the related statements of income and earned surplus for the years 19—, 19—, and 19—. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the aforesaid financial statements present fairly the financial position of X Corporation at (date), and the results of its operations for the years 19—, 19—, and 19—, in conformity with generally accepted accounting principles applied on a consistent basis.

Certificate Covering Portion of Period Under Report.—When a client has changed auditors, the accountant who examines the balance sheet frequently has not examined the income and surplus statement for the entire three-year period. Inasmuch as the entire period must be certified by independent public accountants, the report of the accountant who examined the first year of the period may be similar to the following:

> We have made an examination of the statements of income and surplus and supplementary profit and loss information of X Corporation for the year 19—. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the accompanying statements of income and surplus and supplementary profit and loss information for the year 19—present fairly the results of operations of X Corporation for the year 19—, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Negative Statements in Certificate.—The public accountant's responsibility is to make a reasonable investigation. He cannot lessen his responsibility under the Securities Act by stating in his certificate that he has omitted procedures which are essential to a reasonable substantiation of any item and which he could reasonably have undertaken. A negative statement—to the effect that he has not followed this or that procedure—should not be written into his certificate except in special circumstances and then only with adequate explanation. Any item which for some reason is not susceptible of reasonable investigation or concerning which he may have doubt, even after a comprehensive investigation, calls for an appropriate explanation, qualification, or reservation in his certificate.

It is not necessary to disclaim in his certificate responsibility for titles to assets, for status of franchises, and like matters of law. The practice of disclaiming responsibility for such legal matters, followed by some accountants for a time out of extreme caution, has been generally discontinued.

Summary of Earnings.—There is usually included in the prospectus a condensed summary of earnings showing certain amounts (for example, sales, cost of goods sold or gross profit, selling, general and administrative expenses, other income, income deductions, income before income taxes, provision for income taxes, and net income), for a number of years, often ten years, including the three

years for which more detailed financial statements are furnished elsewhere in the prospectus. The summary should include appended footnotes insofar as they may be considered necessary to give notice of any items or explanations which may be of material significance to the investor.

Although not required by any published rule or regulation of the S.E.C., the summary of earnings is probably the most important single statement in the entire prospectus, and is usually inserted at the recommendation or insistence of the company or the underwriter. The inclusion of such summaries has become so customary that in some registrations the S.E.C. has suggested their inclusion in prospectuses which, in the initial filing, omitted a summary of earnings. This is not to be understood as implying that the Commission insists on the inclusion of such summaries in all registrations, because there are some situations in which, for various reasons, a summary may be of little if any value.

The comments on page 519 with respect to recasting income statements apply equally to earnings summaries.

Responsibility of Accountant Who Has Reviewed Summary.—Whenever possible, registrants and underwriters make arrangements for review of the data in a summary of earnings by independent public accountants. The S.E.C. has ruled on the use of an accountant's name in connection with these summaries. The statement of the Commission's Chief Accountant is, in part, as follows:

> In my opinion, it follows from these statements of principle that summary earnings tables, as a species of financial statements, are primarily representations of management and that the proper function of the independent accountant with respect to them is necessarily limited to an expression of his expert and professional opinion. . . .
>
> . . . . it is my opinion that it is generally improper and misleading for an accountant to permit his name to be used in connection with any period covered by a summary earnings table or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. When the independent accountant has been the auditor for the company throughout the entire period covered by the summary, and his several examinations conformed to generally accepted auditing standards, he would ordinarily need to make only such additional review as would be necessary to satisfy himself as to whether any recasting of the statements originally prepared would be necessary to reflect transactions and adjustments

recorded in later years but clearly applicable to prior operations. If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for him to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first two years of the three-year certified profit and loss or income statement included in the registration statement. . . . .[1]

In cases where the accountant has performed sufficient work to make it appropriate for him to permit the use of his name in connection with a summary earnings table there remains to be considered the form in which he should indicate his opinion. Under the rules promulgated by this Commission, the customary method used by accountants in expressing their expert opinion takes the form of a certificate conforming to the requirements of Rule 2.02 of Regulation S-X. Such certificates make appropriate representations as to the work done, state the opinion of the accountants as to the fairness of the statements presented, and describe clearly any exceptions which the accountants may wish to take. Since, as pointed out earlier, summary earnings tables are a species of income statement it would appear that the accountant's certificate thereon should assume a comparable form, and should be included with the summary or made a part of his report as to the three-year certified statement. If exceptions have been taken by the accountant with respect to any of the information contained in the summary earnings table, special care should be exercised in selecting the language used to introduce the summary to indicate clearly that such exceptions exist and to direct attention to the opinion of the accountant.

If the firm that certifies the formal financial statements for the required three-year period also was the company's independent auditor for the entire period of the summary, the registrant usually authorizes this firm to review the entire summary. If another firm acted as the company's independent auditor for some of the earlier years, then the registrant frequently authorizes this other firm to review the summary for those years and to report upon the results of its review.

In making his review the accountant should consider whether there are any material items (recurring, nonrecurring, operating, or

[1] It is recognized that some auditing procedures commonly applicable in the examination of financial statements for the latest year for which a certified profit and loss statement is filed, such as the independent confirmation of accounts receivable or the observation of inventory-taking, are either impracticable or impossible to perform with respect to the financial statements of the earlier years, and hence would not be considered applicable in the circumstances.

nonoperating) which tend to distort comparison of earnings and possibly give a misleading impression of the trend of earnings unless they are separately disclosed and explained. Any material changes in accounting policy followed by the company during the period covered by the summary should be explained in a footnote. In reviewing the summary of earnings the auditor should also review for the period covered by his report financial statements in annual reports to stockholders and to the S.E.C., and in previous registration statements under the Securities Act. Particular attention should be paid to the statement of surplus and to reserves as shown by the reports for each year to determine whether any items therein should be reallocated to adjust earnings for any year or referred to in footnotes to the summary. If he did not examine the financial statements of the company annually for the entire period covered by the summary, the accountant should inquire as to possible changes in accounting policy followed by the company during the years not examined by him.

Because of the importance attaching to earnings summaries, they should be presented in sufficient detail so that the independent public accountant can properly express the opinion that they fairly present results of operations. Usually this does not add materially to the earnings summaries for prospectus purposes, but revisions (such as, for example, disclosure of dividends and other charges or credits to surplus if material) are required to enable the accountant properly to render an opinion that the earnings summaries fairly present results of operations.

Practice by the profession generally has not yet reached the point where an accountant can insist that his client furnish a tabulation of earnings conforming to the views expressed in the preceding paragraph. This matter is, however, important enough so that whenever his name is used in connection with a summary of earnings, the public accountant should urge his client to furnish a tabulation which does fairly present results of operations rather than certain data.

Certificate with Respect to Summary of Earnings.—The opinion covering his review of the summary may be furnished either as a part of the accountant's certificate on the financial statements for the three-year period appearing in the prospectus, or in a separate report. In the first alternative, if the accountant has audited for the entire period covered by the summary and the formal income statement, his opinion may take the following form:

> We have made examinations of the balance sheet of X Company as of December 31, 19—, the related statement of income and earned surplus for the years 19—, 19—, and 19—, and the statement of income for the years 19— to 19—, inclusive, which latter statement is included in this Prospectus under the heading, "Earnings." Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> In our opinion, the financial statements (pages .... to ...., inclusive) and the statement of income (page ....) present fairly the financial position of X Company at December 31, 19—, the results of its operations for the years 19—, 19—, and 19—, and the results of its operations for the years 19— to 19—, inclusive, all in conformity with generally accepted accounting principles applied on a consistent basis.

The foregoing certificate, insofar as it relates to the summary of earnings, is appropriate only if the summary conforms to the recommendation previously made that changes in earned surplus be disclosed.

If the summary of earnings contains only data concluding with net income, the auditor cannot give an opinion that it presents fairly the results of operations, and then his opinion may take the following form:

> Certificate in the usual form relating to the years 19—, 19—, and 19—, followed by—
>
> We had previously made yearly examinations, similar in scope to that indicated in the first paragraph above, of the financial statements which were reported by the Company for the years 19— through 19—. We have reviewed the summary of earnings which appears under the caption "Earnings" in this prospectus and, in our opinion, it presents fairly the net income and other data shown therein for the years 19— to 19—, inclusive, in conformity with generally accepted accounting principles applied on a consistent basis.

If the certificates covering the statements of any of the years were qualified and the need for the qualification still exists, the necessary qualifications should be included in the foregoing examples.

Letter Covering Review of Uncertified Earnings Summary.—The summary of earnings in the forepart of the prospectus usually covers a period longer than that covered by the formal state-

ment of income. In some cases the public accountant may not have been auditor during the entire period covered by the summary. Although the company may not engage him to examine and report upon the summary for the entire period, they may ask him to review the summary and issue a letter covering such review for their private information. Such a letter may take the following form:

> To the Board of Directors
> X Company
>
> We have reviewed the financial data for the years 19— through 19— which appear in the tabulation under the caption "Earnings" in the prospectus of X Company relating to (name of security).
>
> As explained in the headnote preceding this tabulation, the data therein were summarized in part from the financial statements included in the prospectus and in part, with certain restatements, from statements included in annual reports of the company to its stockholders. Of the statements referred to, those for the years 19— through 19— had been examined and reported upon by us and those for the years 19— through 19— had been examined and reported upon by Messrs. ....
>
> In the course of our review now being reported upon, we inquired into the nature and the amounts of the adjustments given effect to in the summary of earnings and reviewed with officers and employees of the company the accounting principles followed in the resulting restatements. Based upon our examinations and review and the reports of Messrs. .... it appears to us that the information in the afore-mentioned sources has been properly summarized in the tabulation under the caption "Earnings" in the prospectus.
>
> It is understood that this letter is not to be reproduced, in whole or in part, or to be referred to in the registration statement or in any amendment thereto, or in the related prospectus or in any literature used in connection with the offering of securities covered by the afore-mentioned prospectus.

Unaudited Interim Financial Statements.—As stated earlier in this chapter, certain of the most recent financial statements in a registration statement and prospectus are not required by law or S.E.C. regulation to be certified by independent public accountants. Often, however, the directors of the company or the underwriter will insist that all financial statements—including those of the latest interim period—be audited by independent public accountants as an extra measure of protection for all concerned, and the underwriting agreement may so provide. Furthermore, the securities may be of a char-

acter that, if they are to be offered in certain states (Illinois, for example), all the statements must be certified and must be as of a date within 60 days prior to the date of filing. However, directors or underwriters may request that the accountants review the interim statements, not for the purpose of certifying them but as a measure of reassurance short of an audit as to the method of preparation of the statements and the omission of obvious errors.

The review of these interim statements is of value not only to officers, directors, and underwriters but also to the accountant because:

1. He is interested in the transactions and developments during the interim period for whatever additional light they may shed on the statements he certifies. A tax audit in progress at the time of his last examination may have resulted in a substantial adjustment for which provision had not been made, or losses may have been sustained which were not adequately provided for in the certified statements.

2. He wishes to know whether there has been any change during the interim period in the application of accounting principles as compared with the practices followed in the certified statements.

3. The review is also a means of bringing himself up to date on the affairs of his client; see page 540.

As a result of the review considered here it is not to be expected that the independent accountant will be able to certify the interim statements; neither should he issue over his signature and for public information any letter or statement setting forth the scope of his review. It is true that he can be held legally liable only for what he reports, but nonetheless the public is only too apt to see his name and not read what he says. To avoid any misunderstanding on the part of the public, it is better practice, in the opinion of the authors, not to be identified in the eyes of the investing public with uncertified statements. On the other hand, management, directors, and underwriters know the purpose and scope of the review, and there is no objection to an accountant's reporting privately to them.

Letter Covering Review.—A suggested form of letter covering the public accountant's review of uncertified financial statements follows. Note that it is to be addressed to his client, but copies may be furnished to other interested parties if authorized by the client.

(Name of client)
(Address)

We previously submitted our reports dated .... upon our examination of the financial statements and supporting schedules of (name of company) and the consolidated financial statements and supporting schedules of that company and its subsidiaries as of .... and for the years ...., ..., and ..... The afore-mentioned statements and supporting schedules together with said opinions are included in Registration Statement No. ...... filed by (name of company) with the Securities and Exchange Commission.

Pursuant to your request, we have reviewed and made a limited investigation, but not an audit, of the financial statements and supporting schedules of (name of company) and the consolidated financial statements and supporting schedules of that company and its subsidiaries as of .... and for the .... months then ended, which statements and schedules are also included in the above-mentioned Registration Statement. Such statements and schedules were checked in detail by us with the face of the general accounts of the respective companies and were compared with similar data for prior periods. We also made inquiries of officers and other employees of the companies responsible for accounting matters as to the consistency of accounting procedures and as to the existence and disclosure of any material contingent liabilities. Our review and investigation did not reveal to us any information which gives us reason to believe that the afore-mentioned financial statements do not fairly present the position at .... and results of operations for the .... months then ended of (name of company) and of that company and its subsidiaries consolidated.

Insofar as we have determined from our limited review and investigation, the above referred to financial statements and supporting schedules as of .... and for the .... months then ended appear to conform in all material respects with the pertinent requirements of the Securities Act of 1933 and the pertinent published rules, regulations, and instructions of the Securities and Exchange Commission.

It is understood that this letter is not to be reproduced, in whole or in part, or be referred to, in the Registration Statement or in any amendment thereto or in the related Prospectus or in any literature used in connection with the offering of securities covered by the afore-mentioned Registration Statement.

Pro Forma Financial Statements.—Pro forma financial statements are not of importance solely in documents prepared for filing

with the S.E.C., but they are most often prepared and used in registration statements.

Pro forma statements are of many kinds. There are pro forma balance sheets which give effect to the receipt of funds from the proposed sale of new securities and the application of the proceeds toward payment of liabilities and purchase of new assets. There are pro forma balance sheets which set forth the financial position of two or more business enterprises whose merger is proposed. There are pro forma income statements of merged companies which previously operated as separate enterprises; the combined statement of their operations for the period prior to merger is intended to portray the operating results which might have been obtained had the companies been merged at the beginning of or prior to the period covered by the statement. When a company is no longer affiliated with other companies, pro forma statements may attempt to present the operating results that would have obtained had the company not enjoyed the benefits of consolidated tax returns. The number and variety of pro forma statements is almost endless. However, recognition of surplus charges and credits, adjustments of federal income taxes, and other similar adjustments in the years to which they apply does not change the essentially historical character of statements, and statements so adjusted should not be labeled "pro forma."

Pro forma statements often help the reader comprehend an otherwise confusing situation; sometimes they are essential to a proper understanding. Often these statements are more illuminating than the so-called "actual" statements on which they are based, and the public accountant must be alert to see that the prospective investor is furnished not only with all the financial information he needs but also that the information is presented in the most convenient and useful form. This latter consideration frequently dictates the use of pro forma statements, and in recent years prospectuses have placed increasing emphasis on these statements. There has been a tendency to abuse them, and this was the subject of extended discussion at a meeting in 1946 attended by representatives of several investment banking, legal, and accounting firms. It was the consensus of those present that it is not desirable to restate in an earnings' summary extending back over several years interest and other fixed charges on the basis of securities to be outstanding in the future. When it is considered necessary to make such a computation in order to indicate the balance of earnings applicable to equity securities, the computation should be limited to the last fiscal year presented and, preferably, indicated in an explanatory note.

Institute Pronouncements.—In 1923 the membership of the American Institute of Accountants adopted the recommendations of a special committee on the subject of pro forma statements reading as follows:

> I. The accountant may certify a statement of a company giving effect as at the date thereof to transactions entered into subsequently only under the following conditions, viz.:
>
> (a) If the subsequent transactions are the subject of a definite (preferably written) contract or agreement between the company and bankers (or parties) who the accountant is satisfied are responsible and able to carry out their engagement;
>
> (b) If the interval between the date of the statement and the date of the subsequent transactions is reasonably short—not to exceed, say, four months;
>
> (c) If the accountant, after due inquiry, or, preferably after actual investigation, has no reason to suppose that other transactions or developments have in the interval materially affected adversely the position of the company; and
>
> (d) If the character of the transaction to which effect is given is clearly disclosed, i.e., either at the heading of the statement or somewhere in the statement there shall be stated clearly the purpose for which the statement is issued.
>
> II. The accountant should not *certify* a statement giving effect to transactions contemplated but not actually entered into at the date of the certificate, with the sole exception that he may give effect to the proposed application of the proceeds of new financing where the application is clearly disclosed on the face of the statement or in the certificate and the accountant is satisfied that the funds can and will be applied in the manner indicated. It is not necessary that the precise liability shown in the balance sheet before adjustment should actually be paid out of the new money. It is sufficient, for instance where the balance sheet before the financing shows bank loans, if the proceeds are to be applied to bank loans which are either identical with or have replaced the bank loans actually outstanding at the date of the balance sheet. Ordinarily, however, the accountant should not apply the proceeds of financing to the payment of current trade accounts payable, at least not against a normal volume of such current accounts payable, because there must always be such accounts outstanding, and the application of new moneys against the outstandings at the date of the balance sheet results in showing a position which in fact could never be attained. The accountant may usually best satisfy himself that the

funds will be applied as indicated by getting an assurance from the issuing house on the point.

III. In any description of a statement or in any certificate relating thereto it is desirable that the past tense should be used. It should also be made clear that the transactions embodied have been definitely covered by contracts.

IV. When the accountant feels that he cannot certify to such a hypothetical statement, probably because of the length of the period which has elapsed since the accounts have been audited, he may be prepared to write a letter, not in certificate form, stating that at the request of the addressee a statement has been examined or prepared in which effect is given, in his opinion correctly, to proposed transactions (which must be clearly specified). Such letters should be given only in very special cases and with the greatest care.

S.E.C. Rules.—The S.E.C. has a rule under the 1933 Act regulating the use of certain kinds of pro forma statements; a similar rule was promulgated under the 1934 Act. The rule under the 1933 Act is as follows:

Rule 170. Prohibition of Use of Certain Financial Statements.

Financial statements which purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash shall not be used unless the sale of such securities is underwritten and the underwriters are to be irrevocably bound, on or before the date of the public offering, to take the issue. The caption of any such financial statement shall clearly set forth the names of the underwriters and the assumptions upon which such statement is based. The caption shall be in type at least as large as that used generally in the body of the statement.

It will be noted that there are similarities between the S.E.C. and the Institute rules quoted above, but there are also differences. Under the S.E.C. rule, if the underwriters are not to be *irrevocably* bound on or before the date of the public offering to take the issue, pro forma statements giving effect to the financing may not be used. If a public accountant is called on to assist in the preparation of a pro forma balance sheet of the type under consideration, he should ascertain whether the underwriters are to be irrevocably bound on or before the public offering date to take the securities. An agreement is considered by some underwriters to be "firm" despite the existence of a clause by which the underwriter may exercise an "out" if economic, political, market, or other factors at the time of the proposed offering are such as to make the offering, in the opinion solely

of the underwriter, unwise. Under Rule 170 the agreement must be more than firm; at the date of the offering the underwriters must be irrevocably bound.

At the time the pro forma balance sheet is prepared the underwriting agreement is usually tentative—it does not become final, in fact, until shortly before the effective date of the registration statement when agreement has been reached as to the price of the securities. Usually, however, there has been agreement in principle as to the nature of the underwriting commitment, and the accountant may proceed on oral assurance from the company or its counsel that the underwriters will be irrevocably bound on the public offering date. He can satisfy himself on this point by reading the final agreement before the effective date.

Certificate or Letter with Respect to Pro Forma Statements.—There is no objection to issuing a certificate covering a pro forma *balance sheet* included in a prospectus provided:

(1) the underlying financial statements have been examined by the certifying accountant; and

(2) there is compliance with S.E.C. Rule 170, if applicable.

A suggested form of certificate covering a pro forma *balance sheet* follows:

To the Board of Directors of
X Corporation:

We have examined the accompanying pro forma balance sheet of X Corporation as of (date). This balance sheet is based upon the accompanying balance sheet of X Corporation as of (date) (which appears hereinafter with our certificate) and the pro forma adjustments identified in the headnote.

In our opinion, the accompanying pro forma balance sheet of X Corporation presents fairly, in conformity with generally accepted accounting principles, the financial position of the company as it would have appeared at (date) had the transactions set forth in the related pro forma adjusting entries been consummated at that date.

When the public accountant has not examined the underlying financial statements, he is in no position to certify the pro forma statements derived therefrom. He may, however, include in the letter covering his review (see page 531) a paragraph similar to the following:

We have also reviewed the pro forma balance sheet as at .... which is also included in the above-mentioned Regis-

tration Statement. In our opinion, the adjustments set forth in the pro forma adjusting entries have been properly applied in the pro forma balance sheet.

The certification of pro forma income statements or earnings summaries presents a more difficult problem for the public accountant. There are situations in which he may with justification object to having his name identified publicly with certain types of such statements or summaries. He should not refuse to certify pro forma income statements or earnings summaries that merely add the historical results of two or more businesses which have been combined into a single enterprise. This rule is not altered by the fact that intercompany transactions, if any, are eliminated in the pro forma statement. Other pro forma statements, however, should be considered on their merits, and the auditor should bear in mind that these statements are sometimes abused.

Historical Financial Information.—Instructions pertaining to a registration statement on Form S-1 list a number of exhibits which must be filed as a part of the registration statement. Number 17 in these instructions is captioned "Historical Financial Information" and covers the seven-year period preceding the period for which formal income statements are filed in the registration statement. For this seven-year period, the information specified below is required in respect of each company for which balance sheets are filed, whether the accounts named are presently being carried on the books or not:

1. Substantial revaluations of fixed and intangible assets and investments.
2. Restatements of capital shares which resulted in transfers from capital share liability to surplus or reserves; also original issues of capital shares, any part of the proceeds of which was credited to accounts other than capital share accounts.
3. Material amounts of debt discount and expense on funded debt still outstanding, written off earlier than as required under any periodic amortization plan.
4. Material amounts of funded debt or preferred shares retired at a premium or where there remained, at the time of retirement, a material amount of unamortized discount and expense applicable thereto.
5. Material increases or decreases in surplus other than those resulting from transactions specified above, or from the closing of the income account, and dividends.

The information called for by this exhibit may be omitted in respect of any company whose financial statements for its latest full fiscal year have been or will be filed with the S.E.C. under the 1934 Act.

Accountant's Opinion.—The information in Exhibit 17 is not required to be certified, but the registrant or underwriters usually desire to have it reviewed and signed by the accountants, not on the basis of an audit but on the basis of a survey of the accounts named. Below is a suggested form of statement of opinion covering such review:

(Addressed to the client)

We have reviewed the accounts maintained by (company) for the period from (date) through (date) corresponding to those named in Exhibit 17 of Form S-1 of the Securities and Exchange Commission covering matters to be reported under "Historical Financial Information" and, in our opinion, the information required to be reported in such exhibit is fairly presented above.

The Consent.—The 1933 Act provides in Section 7 as follows:

. . . . If any accountant . . . . is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement. . . . .

The Commission's rules relating to consents are contained in the General Rules and Regulations under the Act.

Below is a suggested form of consent which meets the requirements of the Act and the regulations:

We consent to the inclusion of the following certificates and statement of opinion in the registration statement to be used in registering, under the Securities Act of 1933, First Mortgage 4% Bonds of X Company: (1) our certificate dated .... 19— accompanying the financial statements of X Company and of that company and its subsidiaries consolidated which are included in the prospectus; (2) our certificate dated .... 19— accompanying the supporting schedules in such registration statement; and (3) our statement of opinion dated .... 19— included in Exhibit 17 of such registration statement.

(Name of auditor)

(City and date)

If, as frequently happens, the accountant is named in the prospectus as having reviewed the summarized earnings and as an expert, his consent to these references is also required to be filed. This may be accomplished by adding to the form suggested above the following:

> We also consent to the references to our firm under the captions "Earnings" and "Experts" in the prospectus.

If the accountant furnishes a separate report covering the summary of earnings, he is required to consent to the inclusion of this report in the prospectus.

When matter upon which the accountant reports is amended, his consent must be filed as part of the amendment. This may be accomplished by repeating in the amendment the consent which appeared in the original filing and manually re-signing the consent.

It has been the policy of the S.E.C. to require consent of independent accountants to the use of their certificate in a "bring-up" prospectus (that is, one meeting the requirements of Section 10(b) (1) of the Act relating to a prospectus used more than thirteen months after the effective date of the registration statement—see page 541). A suggested form of consent to be used for this purpose follows:

> We consent to the inclusion of our opinion dated .... accompanying the financial statement of .... Company appearing in its prospectus dated ...., to be filed with the Securities and Exchange Commission under the provisions of the Securities Act of 1933.
>
> (Name of auditor)
>
> (City and date)

"Upon Their Authority as Experts."—Because the liability of officers, directors, and underwriters under Section 11 of the Securities Act in respect of particular information appearing in a registration statement depends in part on whether the information purports to be made on the authority of an expert, lawyers for the company and for the underwriters usually insist on the inclusion in the prospectus of a special declaration concerning the information "given upon the authority of accountants as experts." The view of accountants is that, since the financial statements and summaries are representations by the company, such a declaration should be so phrased as to make it clear that the accountant's certificate, rather than the financial statements or summaries, is the information given

upon their authority as experts. Preferably the declaration should be substantially in the following form:

> The financial statements which appear on pages .... to .... of this prospectus have been examined by ...., independent public accountants, and are included in the prospectus in reliance upon the accompanying report of said firm which report is given upon their authority as experts.
>
> The information given in this prospectus under the caption "Summary of Earnings" has been reviewed by said firm and is included in the prospectus in reliance upon the accompanying report of said firm which report is given upon their authority as experts.

Some lawyers insist that the "expertizing" declaration conform to certain of the language in Section 11 of the Act and, in that event, the final clause in each of the above paragraphs may be revised as follows:

> . . . . and are included in the prospectus in reliance upon the accompanying report of said firm and upon their authority as experts.

Registration Statement Speaks as of Its Effective Date.—It was observed earlier in this chapter that the public accountant could be sued under the 1933 Act if the statements he certifies in the registration statement, *when it became effective,* contained a material misstatement or omission. This makes it clear that, when it becomes effective, the registration statement must be true and there must be no material omissions. As far as the independent accountant is concerned, this imposes a duty which does not end with the signing of his certificate and consent and the filing of the registration statement. It means that after the filing and up to the effective date, the accountant must take reasonable steps to ascertain whether anything has happened in the interim which materially affects the statements he certifies. This is a responsibility which, it is true, he shares with others, but it is not a good defense to say that his responsibility is only secondary, that the primary responsibility is the registrant's. Suppose, for example, that on the date of the statements and on the filing date an important lawsuit was pending, as to which no provision had been or could be made for an adverse decision. Shortly after the filing date, a decision is handed down against the registrant. Under the law, unless this information is included in the registration statement, it would possibly be construed as an omission of a material fact which would subject those participating in the registration to the liabilities provided in the statute.

It seems clear that the obligation of the certifying accountant does not end with the filing of the registration statement; he may not thereafter relax his vigilance and simply sit back and wait for the S.E.C.'s memorandum of comments, and, ultimately, the effective date. On the other hand, the independent accountant as a practical matter cannot be expected to keep his audit going continuously until the effective date; this may take weeks or even months. The authors have not interpreted the clause "at the time such part of the registration statement became effective" as requiring the accountant to continue his examination of the books and records to the effective date. It should be his practice, however, to keep in touch with the financial affairs of his client in the manner indicated below.

Necessity of Keeping in Touch with Affairs of Registrant After Filing.—From time to time, after the registration statement is filed and shortly before the effective date, the accountant should confer with responsible, informed officials of the registrant with a view to ascertaining whether, since the date of his certificate, there have been any important developments in the affairs of the company which have a bearing either on the financial statements or on his certificate. He should also review the principal books of account and any statements of the company prepared for internal purposes. If developments indicate that the certificate should be revised or that the financial statements should be changed, the auditor should require that the registration statement be amended before the effective date.

The primary purpose of the conference with company officials and the review of statements is to determine, to the extent possible by these means, whether the over-all picture at the date of his certificate has changed materially as a result of recent developments in the company's business. Usually a conference at the company's main office should suffice for this purpose and it should be unnecessary to send staff accountants to every location visited in the audit. Matters discussed at such a conference will vary with each engagement, and the accountant will have to use his imagination and his knowledge of the company in making his inquiry.

The following items may be considered in such a post-filing conference; however, the list is by no means all-inclusive:

1. *Receivables:* Any important bad debts not adequately provided for? Any large accounts in dispute?
2. *Inventories:* Any significant recent changes in selling prices of finished goods?

3. *Income taxes:* Any revenue agents' report? Any important assessments, penalties, or refunds? Any important recent decisions which might affect this company?
4. *Litigation:* Any important lawsuits instituted or decided? Any newly discovered liabilities?
5. *Sales:* Any significant increases or decreases other than those due to seasonal fluctuations? Any large customers lost? Any material change in unfilled orders? Any unusually large returns or allowances?
6. *Purchase or contractual commitments:* Any material change?
7. *General:* Any important losses such as those due to floods, fires, etc.—whether or not covered by insurance? Any developments in respect of renegotiation of government contracts? Any new legislation affecting the company or its subsidiaries?

Later Editions of Prospectus.—When a prospectus is used more than 13 months after the effective date of the registration statement, the information in the statements must be as of a date not more than 12 months prior to such use [Section 10(b)(1) of the Act]. A prospectus brought up to date in accordance with this provision is commonly referred to as a "bring-up" prospectus. Rule 427 under the 1933 Act deals with bring-up prospectuses and reads in part as follows:

> Information contained in a registration statement may be omitted from a prospectus used more than 13 months after the effective date of the registration statement insofar as information on the same subjects, *including certified financial statements,* as of a date not more than 12 months prior to the use of the prospectus is contained therein. (emphasis supplied)

The italicized portion of the rule quoted above imposes far more stringent requirements than are contained in the instructions for initial registration statements on Form S-1. The result of the rule is this: any company which is under the necessity of keeping its prospectus up to date for years after the effective date of its registration statement must have more than one examination made by public accountants each year. As a practical matter this means semiannual audits. When this has resulted in unreasonable expense, the S.E.C. under certain conditions has not objected when, immediately after the end of the fiscal year, certified financial statements within twelve months were not included if certified year-end statements were furnished as soon as available.

The Underwriting Agreement.—The underwriting agreement frequently contains provisions affecting the certifying public accountants. For example, the agreement may provide that, on or before the closing date, the company will cause the accountants to furnish a letter or letters to the underwriters, in form and substance agreeable to counsel for the underwriters, to the effect that, in their opinion, the financial statements comply with the Act and regulations. The agreement may also provide for issuance by the accountants of a letter with respect to their review of the uncertified interim statements. Counsel frequently requests that the public accountant address such letters to the underwriters; the accountant should insist on addressing them to his client, who can furnish copies to the underwriter. For a suggested form of a "conformity" letter, see page 543; for a suggested form of a letter covering a review of uncertified interim financial statements, see page 531.

Underwriting agreements sometimes contain a provision that the company will also cause the independent public accountants to furnish a letter to the underwriters covering a review of certain items of a financial nature in the narrative section of the prospectus. The public accountant should receive a draft of the underwriting agreement *before it is executed* and review the items, if any, in the prospectus that he is to report upon. If he has any questions as to what is expected of him, they should be raised promptly. Occasionally the response to an item may contain information which the auditor can check, but on the adequacy of which he is not qualified to pass. Furthermore, if he is qualified and the provisions of the agreement require a considerable amount of work on his part, his client should be informed to that effect before the work is begun.

If, pursuant to the agreement, letters are to be furnished, it is desirable that drafts of these letters be submitted in advance of the closing to the company, the underwriters, and their counsel so that they may be informed of what the auditor intends to say in these letters and have an opportunity to clear any questions they may have.

The "Due Diligence" Meeting.—After the registration statement is filed but before it becomes effective, a meeting (called the "due diligence" meeting) is usually held under the auspices of the principal underwriters. Among those attending are representatives of the company whose securities are proposed to be offered, counsel for the company, underwriters and their counsel, independent public accountants, engineers, and appraisers. At this meeting the members of the underwriting group are afforded an opportunity to exercise due

diligence as to their offering in that they may ask any questions which may have occurred to them concerning the company, its business, products, competitive position, recent developments, and prospects. Questions are also invited with respect to anything in the registration statement, including the financial statements as to which the public accountant is frequently expected to furnish the answer.

Conformity Letter.—As stated on page 542, the public accountant is sometimes required to report whether, in his opinion, the financial statements in a registration statement covered by his certificate comply with the Act and the Commission's rules and regulations thereunder. This opinion is usually given in the form of a letter—commonly called a "conformity" letter, or a "compliance" letter. A suggested draft of such a letter follows:

> (Name of client)
> (Address)
>
> We previously submitted our reports dated .... upon our examination of the financial statements and supporting schedules of (name of company) and the consolidated financial statements and supporting schedules of that company and its subsidiaries as of .... and for the years ......, ..., and .... The afore-mentioned statements and supporting schedules together with the said reports appear in Registration Statement No. .... filed by (name of company) with the Securities and Exchange Commission.
>
> In our opinion, the financial statements and supporting schedules covered by our reports conform in all material respects with the pertinent requirements of the Securities Act of 1933 and the pertinent published rules, regulations, and instructions of the Securities and Exchange Commission.

This letter like all letters containing an opinion should be addressed by the public accountant to his client, but there is no objection to furnishing copies to other interested parties, such as underwriters, if this is authorized by the client. The date of this letter is usually the effective date of the registration statement.

Blue Sky Requirements.—Most underwriting agreements provide that the sellers will furnish whatever information is needed in addition to the registration statement to qualify the securities for sale under Blue Sky laws of the various states. In most states the prospectus filed under the Securities Act will also meet the state requirements. In some states additional information is necessary. In Illinois, for example, if the securities to be sold are in Class D

under the laws of that state, the financial statements must be as of a date within 60 days and certified.

When making the arrangements for an engagement under the Securities Act, it is desirable to inquire of counsel for the company or the underwriter whether the "Blue Skying" of the securities will require any additional work on the part of the public accountant.

THE SECURITIES EXCHANGE ACT OF 1934

Principal Provisions.—The Securities Exchange Act of 1934 provides for the registration of national securities exchanges, securities listed on such exchanges, and brokers and dealers trading in the over-the-counter securities markets. The law also prohibits market manipulation by means of wash sales, matched orders, any other deceptive device or fraudulent practice. Under the law the Commission regulates the solicitation of proxies from the holders of listed securities, such trading activities as short sales and stabilizing, the hypothecation of customer's securities, and the business of specialists and odd-lot dealers. Corporate insiders—that is, directors and officers of listed corporations and principal owners of its equity securities—are required to file statements of their holdings of the registered equity securities of their company and also to file monthly reports of changes in such holdings.

Accountant's Liabilities Under the Act.—Under Section 18 of the 1934 Act:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of Section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. . . . .

In its application to accountants certifying financial statements under the 1934 Act, it will be seen that liability is imposed in respect of a misleading statement which results in a person buying or selling a security at a price affected by such statement. Since an income

account is misleading whether it overstates or understates net income, it follows that under this law an accountant may invite a lawsuit if he allows conservatism so to influence his judgment as to result in a material understatement of income.

Limitations of Actions to Recover.—Suit must be brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued [Section 18(c) of the Act].

Registration of Securities Listed on Exchanges.—A corporation seeking to list its securities for trading on a national securities exchange must comply with two distinct sets of requirements: those of the securities exchange and those of the S.E.C. To a large extent this results in duplication of information—both financial and narrative—but under existing regulations this is unavoidable.

Insofar as the Commission's requirements are concerned, a corporation must prepare an application for registration of its securities under the 1934 Act. This application is filed with the exchange and with the Commission. For most commercial and industrial companies, the application is prepared on Form 10, although other forms are prescribed for certain specialized corporations, such as insurance companies, investment companies, and others.

Requirements of Form 10.*—An application for registration under the 1934 Act is not much different from a registration statement under the 1933 Act. Information is required in answer to certain questions (called "items") concerning the organization of the issuer, the general character of its business and changes therein within recent years, the character and location of its principal plants or units, description of its capital securities, names of its officers and directors, remuneration paid to certain persons, the general effect of certain contracts, arrangements, and options, and financial statements.

Financial Statements in Form 10.*—Item 36 of Form 10, and the related instructions, list the required financial statements. Briefly, these are as follows:

1. For the registrant:
   A. A balance sheet as of the close of the most recent fiscal year, unless such year expired within 90 days prior to the date of filing Form 10, in which case the balance sheet may be as of the close of the preceding fiscal year; and

* See note on page 553.

B. Income and surplus statements for the three years ended with the balance sheet date. The income (but not the surplus) statement may be omitted when a consolidated income statement is filed and when the parent company is primarily an operating company and all subsidiaries are wholly owned.

2. Consolidated statements:
   As of the same date and for the same periods as (1) above.
3. Statements of significant unconsolidated subsidiaries:
   As of the same date and for the same periods as (1) above.

Regulation S-X governs the form and content of the financial statements in Form 10, and also specifies the supporting schedules which must accompany such statements. All financial statements and supporting schedules must be certified by independent public accountants.

Historical Financial Information.*—Item 34 of Form 10 requires information beginning with the year 1925 regarding material revaluations, up or down, in investments, fixed assets, or intangibles; restatements of capital stock; and proceeds of new capital stock issues credited to surplus. Information is also required as to the premature write-off of debt discount and expense on issues still outstanding.

It may be noted that Item 34 of Form 10 is similar to the exhibit required by Instruction 17 of Form S-1. Like the latter, the response to Item 34 does not have to be certified by independent public accountants. In practice, however, public accountants frequently assist in its preparation and are requested by management to report on it and sign an opinion covering it for filing with the S.E.C.

Annual Reports.—As a means of keeping up to date the application for registration under the 1934 Act, the S.E.C. has prescribed the filing of annual reports. Of particular interest to public accountants are the annual reports which must be filed by:

1. Corporations which have securities listed for trading on exchanges.
2. Certain issuers which registered securities under the 1933 Act but which do not have securities listed for trading.
3. Certain exchange members, brokers and dealers.

Form 10-K.*—The S.E.C. has promulgated a series of "K" forms to be filed annually by corporations having securities listed on secu-

* See note on page 553.

rities exchanges. For corporations that registered on Form 10, the annual report form is 10-K; for issuers that registered on Form 11, the annual report form is 11-K, and so on. Most issuers of listed securities use Form 10-K.

Form 1-MD.*—There is no provision in the 1933 Act requiring the filing of annual reports. Prior to 1936, therefore, an issuer registered securities under the 1933 Act, the securities were sold, and, unless the securities were listed and registered under the 1934 Act, holders of these securities did not have available to them the same information that was available in respect of securities of listed companies. In 1936 the 1934 Act was amended and thereafter each registration statement under the 1933 Act was required to contain an undertaking to the effect that the registrant would file such additional information and reports as are required in respect of a listed company, but that the undertaking was to become operative only if the aggregate offering price of the securities, plus the aggregate value of all other securities of the issuer of the same class outstanding, computed on the basis of the offering price, amounted to $2,000,000 or more. However, the duty to file such reports is automatically suspended if

(1) the issuer lists and registers any securities under the 1934 Act; or

(2) the aggregate value of the security registered under the 1933 Act, computed on the basis of the offering price, is reduced to less than $1,000,000.

For example, assume that an unlisted company has 100,000 shares of common stock outstanding. It registers 50,000 additional common shares under the 1933 Act and such additional shares are sold at $15 per share. The offering price applied to the entire issue exceeds $2,000,000, and the undertaking referred to above becomes operative. The company later reacquires and retires 90,000 shares, leaving only 60,000 shares outstanding in the hands of the public. The offering price of $15 applied to the 60,000 shares results in $900,000, and hence the duty to file annual reports is suspended.

The annual reports required pursuant to this undertaking are all designated with the suffix "MD." The one most commonly used is Form 1-MD.

Financial Statements in Form 10-K.*—Since Form 10-K is an annual report, the financial statements are for the issuer's fiscal

* See note on page 553.

year and the report is due not more than 120 days after the close of such fiscal year.

The financial statements required constitute Item 8 of the report and are as follows:

1. For the registrant:

   Balance sheet at close of fiscal year;

   Income and surplus statements for the fiscal year. (The income statement may be omitted when the registrant is an operating company, the subsidiaries are entirely owned within the group, and consolidated statements are filed.)

2. Consolidated statements:

   Same as those required for registrant.

   (Financial statements of the registrant or of the registrant and its subsidiaries consolidated may be omitted under the 85 per cent rule as discussed on page 518.)

3. For unconsolidated subsidiaries:

   Balance sheet, income and surplus statements are required for significant subsidiaries; however, statements in respect of all unconsolidated subsidiaries may be omitted when their aggregate assets and sales do not exceed 15 per cent of the consolidated assets and sales; if consolidated statements are not filed, then the subsidiaries' assets and sales are measured against those of the parent.

Regulation S-X is applicable to Form 10-K and specifies the schedules which must be furnished in support of the statements listed above. All statements and schedules must be certified in accordance with the requirements of Regulation S-X.

Financial Statements in Form 1-MD.*—The financial statements constitute Item 10 of Form 1-MD. The instructions for Item 10 provide that the financial statements to be filed shall be those that would be required in Form 10-K if the issuer were a listed company; when, however, Forms 11-K, 13-K, 15-K, and 17-K would be appropriate if the company were listed, then the requirements of these forms are applicable.

Annual Reports of Certain Exchange Members, Brokers, and Dealers.—Rule X-17A-5 requires the filing in each calendar year of a report of his financial condition, as of a date not more than 45 days prior to filing by:

* See note on page 553.

1. Every exchange member who transacts a business in securities directly with nonmembers;
2. Every broker and dealer who transacts a business in securities through any such member;
3. Every registered over-the-counter broker or dealer.

FORM X-17A-5.—The annual report is designated Form X-17A-5 and consists in the main of a financial questionnaire. Regulation S-X does not apply to this report but the financial information is required to be certified by independent public accountants. While the form is of limited interest to most public accountants, there are two aspects which are of general interest: (1) a provision in the rule dealing with the accountant's certificate, and (2) minimum audit requirements set forth in the form.

The accountant's certificate must make certain representations as to the audit. Among other things it is necessary to make a "reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers . . . ."

MINIMUM AUDIT REQUIREMENTS.—As stated above, certain minimum audit requirements are prescribed in Form X-17A-5. These requirements follow:

> The audit shall substantiate the stated assets and liabilities as of the date of the financial questionnaire and the scope and comprehensiveness thereof shall be such as would enable the independent public accountant to express an opinion as to the stated financial condition of the respondent as of that date.
>
> The scope of the audit shall include at least the following:
>
> (1) Comparison of ledger accounts with the trial balances obtained from the general and private ledgers and proofs of the aggregates of subsidiary ledgers with their respective controlling accounts.
>
> (2) Physical examination and comparison with the books and records of all securities, currencies, tax stamps, warehouse receipts, and other such assets on hand, in vault, or in box, or otherwise in physical possession.
>
> (3) Verification of securities in transit or in transfer.
>
> (4) Balancing of positions in all securities and spot and future commodities as shown by the books and records.

(5) Obtaining of written confirmations with respect to the following:[2]

(a) bank balances; (In addition to the reconcilement and confirmation of bank balances as of the date of the audit, the independent public accountant shall, at a later date, after giving ample time for clearance of outstanding checks and transfers of funds, obtain from depositaries cancelled checks and statements of the bank accounts as of such date, and reconcile the balances shown thereon with the balances shown by the books of the respondent.)

(b) open contractual positions and deposits of funds with clearing corporations or associations;

(c) money borrowed and detail of collateral;

(d) accounts, commodities, securities, and commitments carried for the respondent by others;

(e) details of:

(i) securities borrowed
(ii) securities loaned
(iii) securities failed to deliver
(iv) securities failed to receive
(v) when issued contracts
(vi) delayed delivery and other similar open contracts
(vii) open commodity contracts with others;

(f) customers', partners', officers', directors', and respondent's accounts; (Confirmation of these accounts may be in the form of a written acknowledgment of the accuracy of the statement of balances, security positions, and open contractual commitments, other than uncleared regular way purchases and sales, accompanying the first request for confirmation mailed by the independent public accountant.)

(g) guarantees in cases where required to protect accounts guaranteed as of audit date;

(h) all other accounts which in the opinion of the independent public accountant should be confirmed.

(6) A written statement should be obtained from the proprietor, partner (if a partnership) or officer (if a corporation) as to

[2] Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests.

the assets, liabilities, and accountabilities, contingent or otherwise, not recorded on the books of the respondent.

(7) The independent public acountant shall review the methods of internal accounting control of the respondent and its procedures for safeguarding securities.

Other Reports of Issuers.—In addition to the annual reports which must be filed by issuers of listed securities under the 1934 Act and by certain unlisted companies that registered securities under the 1933 Act, such companies are required to file certain other reports containing information which the S.E.C. deems to be important. These reports are filed on Form 8-K and, although the data therein need not be independently certified, accountants are frequently asked to assist in the preparation of this form and they should be familiar with its scope.

FORM 8-K.*—All issuers of listed securities are required to file a report on Form 8-K when certain designated events occur, such as: (1) a substantial revaluation of the issuer's assets; (2) the acquisition of a significant subsidiary whether by purchase or by organization; (3) the sale, liquidation, or other disposition of a significant subsidiary; (4) a substantial revaluation of the issuer's capital stock; (5) the granting or exercise of certain options to purchase equity securities of the issuer from the issuer; (6) the issuance of a new class of securities, or a change of more than 5% in the amount of any outstanding security as last reported, excluding from consideration short-term paper; or (7) the execution of specified contracts. This report must also be filed by issuers that registered under the 1933 Act if the undertaking referred to on page 547 is effective. The report has to be filed by the 10th of the month following the month in which occurred the event necessitating the report.

Certain issuers are also required to file a quarterly report on Form 8-K of sales or operating revenues. All corporations filing annual reports on Forms 10-K and 1-MD must file this quarterly report unless the company is an insurance company, common carrier, or public utility, or is engaged in the production and sale of raw cane sugar or other seasonal single-crop agricultural commodity. The report is due not more than 45 days after the close of the fiscal quarter.

Regulation X-14—Proxy Statements.—Under the authority granted in Section 14 of the 1934 Act, the S.E.C. has promulgated

* See note on page 553.

Regulation X-14 governing the solicitation of proxies in respect of securities listed and registered on a national securities exchange. Public accountants who serve listed companies should be familiar with those portions of the regulation which prescribe the filing of financial statements, especially since, as will be seen, the rules are somewhat flexible and leave room for exercise of judgment.

Regulation X-14 consists of certain rules and Schedule 14A. This schedule itemizes the information required in the proxy statement which must be furnished to the stockholder whose proxy is solicited. The information to be furnished depends in part upon the matters to be acted upon at the meeting to which the proxy relates.

Financial Statements.—Financial statements are required if action is to be taken with respect to:

The issuance or authorization for the issuance of new securities (Item 12),

The modification or exchange of securities (Item 13), or

Certain mergers, consolidations, acquisitions of a going business or its assets, sale of a substantial part of the issuer's assets, or liquidation of the issuer (Item 14).

If any of the above-stated items apply, there must be furnished for the issuer the same prime certified financial statements (i.e., balance sheets and income and surplus statements) and supplementary profit and loss schedule that would be required in an original application for registration under the 1934 Act, except as provided in the paragraph following. Usually registration would be effected on Form 10, and hence the prime statements and schedule in the proxy statement must be as of and for the period prescribed by Form 10. These financial requirements of Form 10 are summarized on page 545. Financial statements must also be furnished in respect of a business proposed to be acquired but these need not be certified.

As to all these items requiring financial statements, however, the Commission's rule provides that any and all financial statements may be omitted when they are not material for the exercise of prudent judgment on the matter to be acted upon at the meeting if the reasons for such omission are stated. Such financial statements are deemed to be material in the usual case involving authorization or issuance of a material amount of senior securities, but are not material in cases involving authorization or issuance of common stock, otherwise than in exchange.

Proxy statements must be filed in preliminary form with the

S.E.C. and definitive copies may not be sent to stockholders until at least ten days after such filing.

When the election of directors is one of the matters to be acted upon at the annual meeting and the proxy is solicited on behalf of the management of the issuer, Regulation X-14 requires that an annual report accompany or precede the proxy statement. The annual report must contain such financial statements for the last fiscal year as will, in the opinion of the management, adequately reflect the financial position and operations of the issuer. This annual report, including financial statements, may be in any form deemed suitable by the management. (If solicitation of proxies is being made in opposition to the management, special rules apply.) The annual report, by Commission rule, is not deemed to be proxy soliciting material or to be filed with the S.E.C. or otherwise subject to the regulation or the 1934 Act except to the extent that the issuer specifically requests that it be treated as a part of such material or incorporates it in the proxy statement by reference. This rule removes the doubt previously entertained by many persons to the effect that the inclusion of the usual annual report to stockholders with a proxy request, makes the report automatically subject to the requirements for proxy soliciting material.

Note: On March 11, 1949, while this book was in preparation, the S.E.C. gave notice that it was considering a revision of certain forms and the adoption of a new form under the 1934 Act, and invited comment as to its proposals. The effect of the proposed changes, briefly, is as follows:

1. *Revision of Form 8-K and adoption of Form 9-K.* The quarterly reports of sales and revenues, now filed on Form 8-K, would be reported on a new form designated 9-K. The scope of Form 8-K would be broadened by calling for information as to changes in the general character of the business; acquisition or disposition of a substantial amount of assets; institution or termination of important litigation; submission of plans of reorganization to any group of security holders; defaults; guaranties, and the institution of bonus, profit-sharing, pension, and retirement plans.

2. *Revision of Form 10.* The revised form would replace present Form 10 and some of the other forms for specialized types of issuers. The items dealing with business and property would be amplified. The revised instructions as to financial statements would require, in addition to the present requirements, information as to 50 per cent owned companies, affiliates whose securities secure an issue being registered, reorganization or succession, and businesses acquired or to be acquired. Historical financial information would be submitted as an exhibit and limited to the seven years preceding the income statements as in Form S-1.

3. *Revision of Form 10-K.* The revised form would replace the present Forms 10-K, 11-K, 13-K, and 24-K and would also be used by companies now filing Form 1-MD. The revised instructions would require additional information as to important changes in the business during the year. New items would be added calling, among other things, for important changes in physical properties and material legal proceedings or significant developments in such proceedings. The instructions as to financial statements would be revised along the lines of the new Form 10, except that, Form 10-K being an annual report, the statements would cover one year.

Mei p. Long form Report

CHAPTER 23

THE LONG-FORM REPORT

The short-form report including the auditor's opinion on the financial statements of a concern under examination is discussed in Chapter 6. As a result of his examination, the auditor frequently has occasion to present reports which include more detail than that customarily included in the short-form report. These detailed reports which frequently are termed long-form reports may vary greatly in form and content depending on their purpose and the nature of the examination or review.

Long-Form Reports When Opinion Is Given.—When the examination of financial statements has been made in order that the independent public accountant may state his opinion regarding them, the long-form report may be given in addition to or in substitution for the short-form report. In either case, the long-form report should include the auditor's opinion; or, if a separate short-form report has been given, a reference to it with proper identification may be sufficient. The opinion may be with or without qualification, may cover the financial statements as a whole, or may be limited to certain statements.

The long-form report may amplify the scope paragraph of the short-form report, may give additional information to interested parties, or both. The additional information provided may vary in kind or emphasis depending on whether the report is directed to management, creditors, stockholders, or prospective purchasers.

Long-Form Reports When No Opinion of Financial Statements Is Given.—The auditor may present long-form reports as a result of limited examinations of the client's financial statements with respect to which no opinion is expected. Another kind of long-form report without opinion is that made upon special examinations, reviews or surveys which are not accompanied with financial statements and in respect of which an opinion would not be appropriate.

Long-Form Reports on Limited Examinations.—Limited examinations of financial statements by independent public accountants may be of various types. Annual audits may be limited in scope by the client, especially if the ownership is identical with management. Monthly or other periodical examinations may be made, accompanied with limited tests of accounting records, of which the principal purpose is the preparation of financial statements for management. Usually the financial statements and accompanying reports on such limited examinations are typed on the auditor's stationery.

If a report does not accompany financial statements presented on the stationery of a public accountant the reader is left in doubt whether the auditor intends an opinion, qualified or unqualified. If the report is merely a recitation of auditing procedures followed or omitted, the reader does not know whether the procedures were sufficient to permit the expression of an opinion. Since the auditor cannot effectively control the uses to which financial statements accompanied by his name may be put, he should adopt practices which minimize the possibilities of misunderstanding by those who use them.

The Statement on Auditing Procedure No. 23, issued in December, 1947, proposed that

> . . . . whenever financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by the accountant in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When the accountant is unable to express an over-all opinion, the reasons therefor should be stated. When the accountant considers it appropriate to

comment further regarding compliance of the statements with generally accepted accounting principles in respects other than those which require the denial of an over-all opinion, he should be careful to indicate clearly the limitations of such comments.

This excerpt covers the situation in which because of serious limitations on scope an over-all opinion cannot be given, but the auditor does express a limited opinion, as discussed in Chapter 6. When a limited opinion is given, it should be reproduced in the supplementary long-form report.

It also applies when a very limited examination is made with the principal purpose of preparing financial statements for management's use. The long-form report accompanying such statements might include a sentence somewhat as follows:

> It will be evident from the limitations in the scope of our work that we have not made an examination sufficiently comprehensive to comply with generally accepted auditing procedures and therefore we are not in a position to express an opinion as to the fairness of presentation in the accompanying financial statements.

Long-Form Reforts on Special Surveys.—The auditor often makes examinations or surveys for special purposes, and his report thereon does not include balance sheets and statements of income and surplus, and there does not arise the problem of stating an opinion. Such reports state the purpose and the results of the examination or survey, and include such schedules or data as may be useful for the purpose. Some of them are discussed below.

Defalcations.—Management, which is directly concerned with prevention and detection of defalcations or embezzlements on the part of employees, should ordinarily be the first to discover wrongdoing by anyone in the concern, but the discovery is frequently made by the public accountant during the course of his examination. When it appears that irregularities exist, a number of questions arise: What is the extent of the money damage? Who are involved in the scheme? What methods were used to conceal the shortage? Can the amount of the shortage be established to the satisfaction of the bonding company? Does it exceed the amount covered by the bond? Can the accumulation of the loss be identified by dates, especially if there are periods not covered by bond, or covered by different bonding companies? Is there possibility of recovery from sources other than the bonding company? Is the amount likely to be of such serious proportions that creditors, stockholders, or other interested parties should be notified promptly?

Often the management feels that the advice and expert knowledge of the independent public accountant should be availed of to assist in obtaining prompt and dependable answers to these difficult questions. The examination made will depend upon many considerations, such as the records available, the extent to which the existing system of internal control might permit extension of the admitted dishonesty, the position of the defaulter in the organization, and other matters. The auditor should consult and cooperate with legal counsel and with representatives of the bonding companies so that the client's interest may be protected at all times. His report should be designed to answer the questions previously suggested, and to provide other information helpful to interested parties.

Specific Accounts.—The auditor may occasionally be asked to make examinations of specific accounts, such as cash and securities. He should make clear to the client the limitations of such an examination, but there is no reason why he should not accept such an assignment. The auditor may examine all accounts at a specific location, such as a branch or factory, either as part of an annual audit or as a special examination. Examinations of consigned stocks of merchandise, or examinations of lessees' accounts when the rental is based on a percentage of sales or net income are not uncommon. The auditor may be called upon to ascertain whether the terms of royalty or licensing agreements have been fully observed. Such agreements frequently include a provision that the periodic reports of the licensee or lessee are to be examined by an independent public accountant.

The reports rendered upon examinations such as those outlined above will state the objective of the examination, describe the audit procedures followed, and if appropriate, state the auditor's opinion as to the subject matter.

System and Methods.—The auditor may be asked to make a survey or review of the client's general accounting methods, or of some section of them, such as customers' billing, cash collections, plant accounting, or cost system. The auditor must first understand the system in use, then determine the proper objectives of the system in the light of the company's needs, and finally recommend changes which he believes will accomplish desired results more effectively or more efficiently. His report in such circumstances usually states in what respects he believes present methods to be deficient, describes changes he thinks should be adopted, and states why he believes changed methods will accomplish the desired results.

For Tax Purposes.—The independent public accountant is expected to be conversant with local, state, and federal tax laws as they affect corporations, individuals, and partnerships in the territory in which he practices. He may be asked to review the client's tax returns with a view to making suggestions for tax savings.

Reports on Financial Statements When No Examination Is Made.—The preparation of financial statements from books of account without examination is well within the scope of the public accountant's services, but such work should be properly differentiated from auditing. It may be desirable at times to submit to a client statements for his review or approval, sometimes well in advance of the completion of an audit, when one is in progress. Financial statements issued in a cover of an accounting firm, even without a report or statement as to the work done or not done, may create the impression that they have the endorsement of the auditor, though that may not be the client's intent in displaying them to third parties.

Unexamined financial statements for which the auditor takes no responsibility and preliminary statements which are subject to change should be submitted on plain paper without the auditor's watermark or letterhead and, if bound, should be in plain covers without the auditor's name. There should be no report bound within the covers, but the headings of the statements may include such wording as "Tentative" or "Without Audit."

Contents of Long-Form Report on Examination of Financial Statements.—Even though a business organization has an accounting staff which prepares current reports of operations containing all financial information required by management, it is not unusual to request the auditor to prepare a long-form report to supplement his formal short-form opinion. A file of long-form audit reports makes a readily accessible record of significant events during the life of the enterprise, and these reports often prove of value many years after they are written. Concerns which do not have accounting staffs which regularly prepare summarized financial data rely on the independent auditor to present annually, or at more frequent intervals, reports which furnish management with significant information in text and schedule form. It is impossible for an able accountant to conduct an audit of financial statements for a period and not have an opinion on the efficiency and accuracy of the accounting department and upon the adequacy of company methods. His opinions, whether or not complimentary, are valuable to management as an outside

check upon the efficiency of the accounting department. Criticism should always be fortified with examples, and accompanied with recommendations for correction. Less important suggestions can usually best be handled in conference with company officials, but sometimes it is desirable or necessary to include them in the auditor's long-form report or in a separate letter to the company.

The first requisite of a long-form report is that it have something of importance to say. The second is that it be written in clear and simple language of unmistakable meaning. The auditor should remember that the report is not primarily for accountants, but for businessmen; technical accounting language should be used only when it is necessary to convey exact meaning.

The following is a condensed outline of a typical long-form report, when the purpose of the examination is to enable the auditor to express an opinion upon the financial statements:

Address and date
Introduction
Summary of important changes during the year
Comments on results of operations
Comments on financial position
Application of funds
Comments on balance sheet items
Bond and preferred stock indenture and profit-sharing provisions
Comments on system of internal control

The long-form report will contain the usual financial statements—balance sheet, statements of income and surplus—supplemented when appropriate with detailed supporting schedules. A schedule reconciling preliminary with final figures is sometimes useful when substantial adjustments have been accepted by the company as a result of the auditor's examination.

Address and Date.—The considerations as to addressing and dating the long-form report are similar to those discussed in Chapter 6 relating to the short-form report.

Introduction.—The introduction should identify the financial statements covered by the auditor's examination and usually should include a statement of his opinion regarding them. If the auditor's opinion is not included in the introduction, it is usually given at the conclusion of the report. If in addition to the long-form report he has or intends to present a short-form report, the latter may form the introduction to the former. If the auditor's opinion is unqualified, a

reference to the existence and date of the short-form report may suffice.

SUMMARY OF IMPORTANT CHANGES DURING THE YEAR.—It is usually a good plan to summarize briefly any important happenings during the year before beginning the detailed comments. There may have been financing operations, either to refund existing obligations or stock issues, or to furnish additional capital, or both. A description of the issues sold or retired, and the disposition of the proceeds for new plants, additional working capital, research or otherwise, is usually of interest. The company may have embarked upon marketing new products, or expanding its markets for standard lines. There may have been changes in sales or other policies which have a significant effect upon operations. Inauguration of a pension or profit-sharing plan, or developments in labor relations may be proper subjects for comment at this point.

COMMENTS ON RESULTS OF OPERATIONS.—A condensed comparative statement of income is frequently used as a starting point for comment pertaining to results of operations. It may take the following form:

	1948	1947	Increases Decreases*
Net sales	$230,000	$200,000	$30,000
Cost of goods sold	184,000	152,000	32,000
Gross profit	46,000	48,000	2,000*
Per cent of net sales	20%	24%	4%*
Selling expenses	14,000	11,000	3,000
General and administrative expenses	14,000	10,000	4,000
Total expenses	28,000	21,000	7,000
Per cent of net sales	12.2%	10.5%	1.7%
Income before federal taxes on income	18,000	27,000	9,000*
Per cent of net sales	7.8%	13.5%	5.7%*
Provision for federal taxes on income	6,800	10,300	3,500*
Per cent of net sales	2.9%	5.1%	2.2%*
Net income	$ 11,200	$ 16,700	$ 5,500*
Per cent of net sales	4.9%	8.4%	3.5%*

The foregoing comparison is of a kind which should stimulate the auditor's inquiries into the reasons for the results shown. For example, he may inquire why the rate of gross profit shows a marked drop with increasing sales, and why the rate of selling expense per

dollar of sales increased in spite of a substantial increase in sales; such increase is ordinarily accompanied by lower selling expense per dollar of sales. He should want to know why general and administrative expenses increased 40 per cent when the volume of business was only 15 per cent higher. The auditor should look beneath the surface and by test and inquiry be sure he has all the facts before commenting on variations in gross and net profits.

There are a number of possible variations of form in condensed statements of income. Sometimes the current year is placed in the right-hand column; frequently additional columns are provided to show percentages to net sales of all items.

Comments on Changes in Financial Position.—A comparative balance sheet indicates the increases and decreases in assets, liabilities, and capital during a given period, but it discloses effects, not causes. A statement of application of funds, in a general way, indicates changes in financial condition, sources of additional current funds, and how these funds were applied.

Application of Funds.—Funds are derived from undistributed profits during the period, sales of fixed assets, increase of capital through issue of securities, or from other sources. Usually such funds are applied to increase working capital, to purchase additional fixed assets, or to retire bonds and preferred stock.

In preparing a statement of application of funds, consideration should be given to any increases or decreases disclosed by the comparative balance sheet which result from book entries which do not represent cash transactions, e.g., provision for depreciation or write-off of stock and bond discount. Although depreciation and amortization provisions affect profits, they must be added back to net income in order to determine the funds provided.

In the following illustration of an application of funds statement, which is not intended to be all-inclusive, it should be noted that:

Capital stock in the amount of $30,000 was issued at par;

Net income for the year was $56,000;

A cash dividend of $30,000 was paid during the year;

Provision for depreciation for the year amounted to $7,000 and was added to the depreciation allowance account; and

Machinery and equipment which cost $12,000, and for which the depreciation allowances heretofore made totaled $6,000, was sold for $4,000, thus showing a loss of $2,000.

Comparison of Condensed Balance Sheets
at December 31, 1948 and 1947

	December 31 1948	December 31 1947	Increases Decreases*
ASSETS			
Current Assets:			
Demand deposits in banks and cash on hand	$ 73,000	$ 30,000	$ 43,000
Notes and accounts receivable, less allowance	160,000	169,000	9,000*
Inventories	220,000	180,000	40,000
	453,000	379,000	74,000
Land	30,000	30,000	
Buildings	68,000	65,000	3,000
Machinery and equipment	112,000	97,000	15,000
Allowance for depreciation	47,000**	46,000**	1,000**
Deferred charges	8,000	4,000	4,000
	$624,000	$529,000	$ 95,000
LIABILITIES			
Current Liabilities:			
Notes payable	$ 30,000	$ 18,000	$ 12,000
Accounts payable	18,000	3,000	15,000
Accrued taxes	16,000	4,000	12,000
	$ 64,000	$ 25,000	$ 39,000
CAPITAL			
Capital stock	$530,000	$500,000	$ 30,000
Earned surplus	30,000	4,000	26,000
	$560,000	$504,000	$ 56,000

** Deducted.

Statement of Application of Funds
for the year ended December 31, 1948

Sources of funds:			
Net income			$56,000
Add back, deductions made in determining net income which do not represent current cash expenditures:			
Provision for depreciation		$ 7,000	
Loss on sale of fixed assets		2,000	9,000
Funds from operations			65,000
Issuance of additional capital stock			30,000
Sale of fixed asset			4,000
			$99,000
Disposition of funds:			
Dividend paid		30,000	
Increase in investment in fixed assets:			
Buildings	$ 3,000		
Machinery	27,000	30,000	
Increase in noncurrent prepaid expenses and deferred charges		4,000	
Increase in net current assets, per schedule below		35,000	$99,000

Schedule of Changes in Net Current Assets

	December 31 1948	1947	Increases
Current assets (see above)	$453,000	$379,000	$74,000
Current liabilities (see above)	64,000	25,000	39,000
Net current assets	$389,000	$354,000	$35,000

The statement of application of funds provides information regarding changes in the financial position of the business not all of which is apparent from the comparison of balance sheets. The foregoing form of statement of application of funds should be varied in accordance with the factors most significant in a particular situation. Certain items entering into changes in net current assets, such as the apparent additional borrowing on notes payable in the illustration above, may be brought into the statement as a source or disposition of funds. Or, if the most important source of funds during the period was found to be an issue of bonds, rather than operating profits, the statement may start with the proceeds of the bond issue. The statement may be made one of the most useful contained in the long-form report, because many businessmen understand it more readily than the more conventional financial statements upon which it is based.

Comments on Balance Sheet Items.—In this section of the report it is customary and appropriate to elaborate on the summarized comments presented in the introduction regarding the scope of examination and findings resulting from the examination. Also included may be summarized analyses showing the composition of principal items of assets and liabilities and extension of the description of bases on which they are stated in the balance sheet. Data illustrative of material which may be included are mentioned in the paragraphs immediately following.

Cash.—The presence of an unwarranted number of vouchers in working cash funds or of unauthorized employee advances and loans might call for comment in the report. Unusually large balances carried on deposit with small banks or small balances which might be consolidated to avoid service charges may well be mentioned.

Accounts Receivable.—Readers of a report are usually interested in the status of the accounts receivable from customers and the auditor's opinion of the adequacy of allowances for losses on collec-

tion of accounts. If the company is a borrower on short-term credit, the lender may wish to see analyses of accounts receivable by age, preferably in comparative form with the preceding year. If some accounts are past due, indication of amounts collected since the balance sheet date is of interest. The average period of collection over a given time may be computed, and compared with the company's usual credit terms. Unusual credit terms involving large amounts of receivables and exceptionally large percentages of sales to individual customers may be proper subjects for comment. The extent to which receivables have been confirmed should be stated.

Inventories.—The auditor, as a result of his examination of inventories, should have a comprehensive knowledge of the client's methods of inventory control, inventory-taking and pricing, and will be able to comment upon these methods and suggest improvements. A summary schedule of inventories by classification or location or, if significant, a statement of obsolete or slow-moving material may be of interest.

His report may also describe in some detail the basis on which the inventory is stated and methods of computing cost or market.

An important measure of the efficiency of a merchandising business is its inventory turnover, computed, if feasible, by departments or by classes of product. Substantial profits can be made on a narrow margin if an inventory can be turned over many times during the year.

Plant Assets.—Supplemental information concerning plant and property, depreciation allowances, and the client's policy regarding repairs and depreciation will be of interest to many readers of audit reports. If assets are carried at other than cost, the basis used should be described in ample detail. A statement may be submitted setting forth classes of plant, with related amounts of accumulated allowances for depreciation together with depreciation rates applied, as well as analyses of changes in plant asset accounts and in related allowances because of plant additions, removals, and depreciation provisions during the period under audit. Changes in depreciation rates and in accounting policies relating to fixed assets, if significant, are always worthy of discussion in audit reports.

Noncurrent Prepaid Expenses and Deferred Charges.—The long-form report usually includes a more detailed list of the items included in this caption than is customarily shown on the face of the balance sheet. If there are unusual items included, or items being amortized

over arbitrary periods, a description of the circumstances and basis of amortization is in order.

Liabilities and Reserves.—Unusual liabilities may be described in this section of the report. Details may be given of bank or other short-term borrowings. The status of the company's liability for federal income taxes is frequently of interest. If long-term debt matures serially, or is being retired through a sinking fund, details of these operations may be given. If the company has noncurrent reserves for certain liabilities, such as for fire insurance, workmen's compensation, or maintenance, the character of the reserve may be discussed and often a summary analysis given of changes during the year.

Capital Stock.—Changes in the capital structure during the year may be outlined, and the operations of preferred stock sinking funds, transactions involving treasury stock, stock dividends, exchanges of securities, reorganizations, or new financing described in some detail. In an initial report, or a report addressed to a new management, it is useful to include a brief history of the several classes of securities then outstanding with a description of their more important provisions.

Surplus.—If the statements of surplus included in the financial statements are condensed to some degree, any amplification which may be desirable may be included in this section of the long-form report. If as a result of reorganization there are entries affecting both capital stock and surplus, the tie-up may be made clear in a schedule.

Bond and Preferred Stock Indenture and Profit-Sharing Provisions.—The auditor's examination should be such as will satisfy him that all accounting provisions of indentures under which the client company's securities were issued have been satisfactorily observed during the year under review. These include sinking fund provisions, requirements as to asset ratios, dividend restrictions, preferences, and the like. The auditor's report should refer to any violations of the provisions and restrictions which he has noted. When profit-sharing plans for the benefit of officers and employees are in effect, a summary of the calculation of the amount to be distributed for the year is of interest. Details of the distribution ordinarily are confidential and usually are not included in a long-form audit report.

Comments on System of Internal Control.— An expression of opinion regarding the adequacy of the client's accounting records

may properly be a part of the auditor's report. He should be in a position to suggest improvements which will make for better control over operations, provide more useful information for the management, or result in simplification of methods and consequent economies. The auditor's analyses of expenses may lead to suggestions regarding means of effecting savings. He should consider not only the adequacy of the records accounting for past financial transactions but also the advisability of introducing or extending budgetary methods to facilitate more careful planning and coordination of future transactions.

Elsewhere in this book will be found discussions of methods of internal control to minimize bookkeeping errors and guard against possibilities of fraud and peculation. The review of such methods is ordinarily a part of the auditor's examination. Investigation of safeguards afforded by the client's system and review of the work of the internal audit staff, if there be one, are important matters which may be covered in the audit report or, if deemed more appropriate, in a supplemental letter. Frequently this investigation can be accomplished prior to the end of the fiscal period and may be made the subject of advance reporting. Any material inadequacy of procedures or laxity in their execution should be brought to the attention of a responsible officer of the client company without undue delay. The matters subject to criticism may be discussed informally with the client, but if of major importance the auditor should not fail to put them in writing.

The auditor, as a result of his examination, will ordinarily have opportunities to offer constructive advice to his client as to methods of preparation and form of statistical reports. He should not attempt any extensive revision of a client's system of reports unless he is authorized by the client to undertake the work and he has had the necessary specialized training, but he can, nevertheless, take advantage of opportunities for suggesting specific improvements in reports to executives.

It contributes to harmonious internal organization, as well as to reliability of records, if the accounting department of a business organization is responsible for all records and reports, including cost records, time records, production statistics, sales statistics, and perpetual inventory records. This does not mean that the accounting department should dictate the type of information which executives are to receive for the purpose of controlling the activities of their organizations. But the accounting department should ascertain what information is required by the executives and assume responsibility

for furnishing it. At the same time underlying records should be prepared as designated by the accounting department, and these records should be summarized by the accounting department and become part of the accounting records of the company. Whenever possible, formal accounting records should be so planned that statistical information is coordinated with the accounting system and supports the results of operations reflected in financial statements. This coordination gives added assurance that statistical information is reliable. Furthermore, by concentrating supervision of all records in the accounting department, duplication of records and work may be avoided.

Use of Comparisons, Analyses, and Ratios.—The auditor may confine the figures and comments in his report to those relating to the immediate period of his investigation. To make reports interesting and informative, auditors frequently include statistical and comparative information of earnings and operations of previous years which they have not examined. If such information is furnished, the report should clearly indicate which periods have been examined and which figures are quoted from the client's records without examination.

Following are examples of ratios and turnover figures which can sometimes be embodied in an audit report to advantage, particularly in comparison with similar data for other fiscal periods:

- Ratio to net assets of:
  - net income for the year
  - fixed assets
- Turnover of inventories
- Turnover of accounts receivable
- Ratios of:
  - current assets to current liabilities
  - profits before interest to interest on long-term debt
  - net income to preferred dividend requirements
- Percentage of costs, expenses, and net income to net sales
- Net income per share of common stock outstanding
- Net assets per share of common stock outstanding

If the accounts are departmentalized, some of the data may be given by departments. Ratios and percentages, woven into the report at appropriate points, help to make it more interesting and informative.

Statistical Records and Use of External Statistics.—In industries in which there is a single unit of production—such as tons,

pounds, barrels, or gallons—the sales accounts generally are kept not only in amounts but also in quantities. Under such conditions it is usually possible to state the income and expenses per unit of production or sales as well as in total dollars. Records of quantities and amounts, not only of sales, but also of materials purchased and used, enable the auditor to make a comparison of the quantity of materials used with the resultant quantity of finished product.

There is available a constantly increasing volume of informative business statistics compiled by government bureaus, chambers of commerce, research bureaus, financial institutions, and trade associations. The auditor should take advantage of comparisons which these sources of information afford. He may be able to make valuable comparisons of the client's production costs and various ratios with those of the industry as a whole.

Additional Information When Purchase Is Contemplated.—An examination made on behalf of a prospective purchaser usually covers a number of years and some of the information desired is of a more general character than that ordinarily obtained in a balance sheet audit. A good deal of this information is of continuing interest, and should be retained in the permanent file. It is included in a long-form audit report only in special circumstances. The following indicates the material which may be obtained:

1. History of the business. Data regarding the origin of the concern; its incorporation; location, and subsequent growth; formation, acquisition, and purpose of subsidiaries; and corporate powers as reflected in articles of incorporation and by-laws.
2. Products. Quality and character of principal and secondary products, and by-products; source of demand for products—consuming public or other manufacturers; and character of demand—fluctuating, seasonal, or relatively constant.
3. Production methods and processes. Relative importance of raw materials, fixed investment, and labor in the manufacturing process; principal raw materials, source of supply, character of market therefor; character of labor required, as to skill, sex, union affiliations, and apparent availability; and relative magnitude and character of machinery used in the manufacturing process.
4. Methods of sale and distribution. Number and character of consumers; whether sales are made through salesmen, branch

offices, dealers, or jobbers; necessity for and type of advertising employed; and relative importance of selling and distribution expenses.

5. Status of company in the industry. Comparison of production with that of competing companies in the same industry and with total of the industry; basis of competition with competitors—quality, price, and service; whether concern has strategic advantage over competitors as to location (nearness to raw materials or to markets), or as to labor costs; general standing of concern in the industry; and dependence upon tariff protection, patents, secret processes, and formulae.
6. Management and control. Distribution of stock ownership; identity of management with stock ownership; form of organization and organization chart; relationship between and control over the various departments—sales, production, engineering, financial, or research; personal data re executives—age, experience with and prior to affiliation with concern, salaries, bonuses, and stock ownership; extent to which management relies on monthly or other periodic reports as a guide to management policies; extent to which reports are prepared but not used by those for whom intended; and extent of coordination of departmental activities.

Other Data.—Inventories may present unusual questions of obsolescence, overstocking, or unbalance. Purchase commitments and unfilled orders may assume even more than their usual significance. If any substantial portion of the company's operations is conducted in leased premises, terms of leases—which may be advantageous or disadvantageous to the buyer—should be ascertained. Schedules of sales in detail for as many as ten years, classified on as many bases as statistical records will permit; comparative statements of costs and expenses, with ratios to net sales; analyses of surplus showing rates and amounts of dividends for a period of years; and other details suitable to the circumstances may be included.

Mechanical Preparation of Report.—All reports, whether short- or long-form, should be typed in the auditor's office with as many copies as is necessary for distribution, and with at least one copy preserved for his permanent file. The mechanics of report work is usually concentrated in a special department of the auditor's office.

The work is frequently divided into two functions: first, typing, and second, proofreading and review for correctness of arithmetic,

grammar, and cross-references. This department should be so organized and staffed that it may be entrusted fully with the accuracy of these details, leaving the principals free to review reports as to matters of accounting policy, adequacy of disclosure, form of presentation, style, and suitability.

Typing of audit reports is a specialized task which can be accomplished satisfactorily and economically only by typists of considerable training and experience in this field. Acquaintance with various tabulating devices and other mechanical aids is of importance.

Reports should be proofread and reviewed by experienced individuals with some knowledge of accounting. It should be an invariable rule that no report leaves the auditor's office unless it has been carefully read and checked by the report department.

Reports upon examinations made by independent public accountants, whether qualified or unqualified, should be bound in durable covers bearing the auditor's name, and should be typed on good quality paper, bearing, if possible, the watermark of the auditor, to make difficult separation of the report from the financial statements and to identify the work of the auditor.

Discussion of Draft of Report.—Usually it is well to arrange a conference for discussion of a preliminary draft of the report, to ascertain the views of the client in advance so as to avoid any possible misunderstanding, and to cooperate in making the report most useful to the client. Close cooperation between the auditor and the client's officers promotes efficient conduct of the examination and tends to enhance the value of the resulting report.

APPENDIX

QUESTIONNAIRES FOR EVALUATION OF INTERNAL CONTROL

Chapter 5 of this book discusses the nature of internal control, its significance to management, and the profound effect which it has as an indicator of the nature of the audit procedures required by the circumstances of a particular case and of the degree to which such procedures should be employed. The features of internal control having particular applicability to the various asset, liability, income and expense accounts are discussed in more detail in the chapters relating to each of those accounts. It has been stated that:

> The review of internal control is one of the most important of the steps in proper planning of the audit and must not be casually undertaken or carelessly performed. In so far as the circumstances permit, the auditor should independently acquire a personal familiarity with the procedures and methods in use. A systematic and clear record

should be made of the facts developed by the review. In his record, the prudent auditor will make a clear distinction between those facts which he has independently established and those which, by force of circumstances, he has accepted based upon oral representations. (Tentative Statement of Auditing Standards issued by Committee on Auditing Procedure of American Institute of Accountants)

The appended questionnaires have been designed to facilitate the review and evaluation of the degree of internal control. Use of the questionnaires in hundreds of cases has indicated that they are suitable when applied with judgment. They should *not* be considered to embrace all situations which might be encountered in specific examinations; when conditions arise which are not covered in the appropriate questionnaire, the auditor should amplify it to the extent required. It is believed that the method of using the questionnaires will be apparent from a review of their content in conjunction with the explanatory comments contained in the following paragraphs.

Each question has been so worded that an affirmative answer indicates soundness of the phase of internal control covered by the question. Most of the questions deal with matters of fact; those which involve the exercise of judgment or expressions of opinion are distinguished by numbers beginning with 20. Most of the information upon which the responses are based is obtainable by the auditor as a result of his usual auditing procedures; answers to some of the questions will necessarily be based on information furnished by the client's personnel. The answers as inserted on the questionnaire should therefore be coded to indicate the source of the answer—such as "A" for auditor and "C" for client. Not all questions will be applicable in any one examination. It is important to indicate those inapplicable and this too may be accomplished by coding these questions with the letter "I". The coding is simplified if the code letters "A", "C", and "I" are inserted as column headings at the left of the questions. The auditor may then record his findings systematically by placing a check-mark in the appropriate column.

A review of the system of internal control for the purposes outlined on pages 54-55 is not intended to be the equivalent of a system examination; in most cases, therefore, a simple "yes" or "no" answer is sufficient. Elaboration sometimes may be desirable, especially when the question is inapplicable or when the answer is based upon unsubstantiated information furnished by the client.

When the replies to questions are in the negative, especially when representing an undue proportion of replies in any one section of the questionnaire, the auditor should consider the extent to which his audit program relating to the subject should be modified or expanded.

COMMERCIAL AND INDUSTRIAL COMPANIES

PETTY CASH FUNDS

1. Is the imprest fund system used?
2. Is primary responsibility for each fund vested in only one person?
3. Are petty cash vouchers:
   - (a) Required for all disbursements from the fund?
   - (b) Prenumbered?
   - (c) Signed by the recipient of the funds disbursed?
   - (d) Executed in ink or otherwise to make alterations difficult?
   - (e) As to amounts, spelled out as well as written in numerals?
   - (f) Approved by a responsible official?
   - (g) Canceled, together with supporting documents, so that they cannot be misused thereafter?
4. Are checks for reimbursement made out to the order of the custodian?
   - (a) If not, specify.
5. Are funds audited by frequent and surprise counts by an internal auditor or other independent person?
6. If imprest fund is represented in whole or in part by bank account, has bank been notified that no checks payable to the company should be accepted for deposit?
7. Are petty cash funds limited to:
   - (a) A reasonable amount?
   - (b) Expenditures of a petty nature?
   - (c) Expenditures not exceeding a fixed amount?

20. Are the regular duties of the custodian of such a nature as would not necessitate his having access to:
    - (a) Remittances and other deposits?
    - (b) General accounting records?
21. Is there an adequate internal audit of reimbursement vouchers and attachments?
22. If custodian is authorized to cash checks:
    - (a) Is approval of someone other than the custodian required before checks may be cashed?
    - (b) Are all cashed checks deposited or cashed at the bank without delay?

CASH RECEIPTS

1. If cash receipts represent principally payments made in person by customers:
   (a) Are cash register tapes, counter sales slips, collectors' receipts or other similar forms used as proofs of cash receipts?
   (b) Are such proofs checked by an employee independent of the person directly receiving the cash, to determine that the proofs agree with amounts recorded and deposited?

2. If cash receipts represent principally payments mailed by customers:
   (a) Is the mail opened by an employee independent of persons directly responsible for:
      (1) Making up the cash deposit?
      (2) Posting customers' accounts receivable ledgers?
   (b) Is a detailed record of receipts prepared by the employee who opens the mail?
   (c) Is such record used by someone other than employees directly responsible for making up the deposit and posting customers' accounts receivable ledgers to verify amounts recorded and deposited?

3. Are each day's receipts:
   (a) Recorded on the books when received?
   (b) Deposited intact and without delay?

4. Does the person responsible for making up the deposit:
   (a) Turn over such receipts to another employee who deposits cash in the bank?
   (b) If so, are the duties of such other employee of such a nature as would not necessitate his having access to:
      (1) Customers' accounts receivable ledgers?
      (2) Customers' statements?

5. Is a duplicate deposit ticket, after authentication by the bank, received by an employee who is independent of:
   (a) Person directly responsible for making up the deposit?
   (b) Employee who deposits cash in the bank?

   Are such deposit tickets compared in detail with the cash receipts record?

6. Are deposit or collection items which are charged back by the bank as uncollectible delivered directly to an employee other than the person directly responsible for making up the deposit?

7. If deposit or collection items which are determined by the bank to be uncollectible are "redeemed" by the company instead of being

charged back by the bank, are the duties of the employee who makes the "redemptions" independent of:

(a) Cash receipts functions?
(b) Customers' accounts receivable ledgers?
(c) Customers' statements?

8. Are post-dated checks:
   (a) Held in safekeeping until deposited?
   (b) Recorded on the books when received?
9. Are other deficient remittances from customers:
   (a) Deposited promptly?
   (b) If not, are they:
      (1) Held in safekeeping?
      (2) Recorded on the books when received?
   (c) Referred to credit manager or other designated employee for investigation and settlement?
10. Where branch offices make collections:
   (a) Are such collections deposited locally in a bank account subject only to home office withdrawal?
   (b) If so:
      (1) Are duplicate deposit slips, authenticated by bank, mailed directly by bank to home office?
      (2) Are such duplicate deposit slips compared in detail with advices from branch office?
   (c) Are monthly statements mailed directly to the home office by such bank?
11. Are negotiable assets, other than currency, checks or drafts in custody of an employee independent of persons directly responsible for cash receipts?
12. Are all bank accounts authorized by Board of Directors?
20. Are duties of person who makes up the deposit of such a nature that it is unnecessary for him to have access to:
   (a) Customers' accounts and notes receivable ledgers?
   (b) Customers' statements?

CASH DISBURSEMENTS
(excluding pay roll disbursements)

1. Are checks used for following purposes prenumbered by printer:
   (a) Regular cash disbursements?
   (b) Others—specify (e.g., dividend disbursements, etc.):
      (1)
      (2)
      (3)

2. Are prenumbered checks which have been spoiled and voided replaced by other prenumbered checks of the same series?
3. Is supply of unused checks under adequate control?
4. Are spoiled checks:
   (a) Retained and filed?
   (b) Voided in a manner which precludes subsequent use?
5. Is a check protector used?
6. Is the practice of countersigning checks followed in respect of checks drawn for:
   (a) Regular cash disbursements?
   (b) Others (specify):
      (1)
      (2)
      (3)
7. Must one of the signatures on each check be that of an employee whose duties do not include:
   (a) Posting accounting records?
   (b) Recording cash receipts?
   (c) Handling petty cash funds?
   (d) Approving vouchers for payment?
8. Are checks mailed by an employee whose duties do not include:
   (a) Posting accounting records?
   (b) Recording cash receipts?
   (c) Handling petty cash funds?
   (d) Approving vouchers for payment?
9. Is the signing or countersigning of checks in advance prohibited?
10. Where a mechanical check signer is used:
    (a) Is the operation of the signature machine under control of the authorized user?
    (b) Does such authorized user qualify under Question 7?
11. Is the practice of drawing checks to "cash" prohibited?
12. Are transfers from one bank to another promptly recorded?
13. Does supporting data accompany checks when they are submitted for:
    (a) Signature?
    (b) Countersignature?
14. Is there evidence that supporting data has been examined by persons signing checks?
15. Are bank reconciliations made every month for:
    (a) Regular bank accounts?

(b) List exceptions:
(1)
(2)
(3)

16. Are bank reconciliations made by employees whose duties do not involve the recording or handling of cash, including signing of checks?

17. Do the employees who are responsible for bank reconciliations receive unopened envelopes containing bank statements directly from the banks?

18. Do employees when reconciling bank accounts:
    (a) Account for sequence of check numbers?
    (b) Examine as to:
        (1) Date?
        (2) Payee's name?
        (3) Bank cancellations?
        (4) Endorsements?
        (5) Authorized signatures?

19. Are inadequately endorsed checks paid by banks returned to such banks for proper endorsement?

20. Is there an adequate procedure for the control of old outstanding checks?

21. Are stop-payment notices and related entries under adequate accounting control?

NOTES RECEIVABLE

1. Are notes receivable (including renewal notes) approved by an officer or a designated employee prior to acceptance?

2. Is a detailed record of notes receivable maintained?

3. Is such record periodically balanced with the general ledger control account?

4. Are notes receivable endorsed for reductions when partial payments are made?

5. Is a record of discounted notes receivable kept so as to reflect the contingent liability?

6. Does the company periodically request customers to confirm unpaid balances of notes receivable?

7. Are unpaid balances of notes receivable periodically reviewed by an officer or a designated employee to ascertain delinquent amounts?

8. Does a responsible official approve the write-off of uncollectible balances of notes receivable?

9. Are the duties of the custodian of notes receivable of such a nature that it is unnecessary for him to have access to:
   (a) Cash records?
   (b) General books of company?

10. Is negotiable collateral in custody of an employee other than those who are responsible for:
   (a) Cash receipts?
   (b) Notes receivable record?

11. Are notes receivable and collateral kept with an independent custodian, such as a bank or trust company?

12. If not:
   (a) Are they kept under lock and key?
   (b) Are they kept in a safe deposit vault?
   (c) Are they periodically inspected?
   (d) Is it necessary for more than one person to be present to open the box?
   (e) Are such persons independent of notes receivable record keeping?

20. Is proper control exercised over recoveries on notes previously written off?

ACCOUNTS RECEIVABLE

1. Is the total of the individual accounts regularly balanced with the control?

2. Are the accounts aged periodically for review?

3. Is the aging occasionally checked by an employee independent of the one who prepares it?

4. Are delinquent accounts periodically reviewed by a responsible official?

5. Are statements of account regularly sent to *all* customers?

6. If not, are there some equivalent means of control?

7. Are statements independently checked to accounts and kept under control to insure their being mailed by someone other than the accounts receivable bookkeepers?

8. Are accounts with customers confirmed by a member of the client's staff who is independent of:
   (a) The cashier?

(b) Credit manager?
(c) Accounts receivable bookkeeper?

9. Are disputed items handled by someone other than accounts receivable bookkeepers or the cashier?

10. Does a responsible official approve:
(a) Write-off of bad debts?
(b) Adjustment credits?

11. Are credit memoranda:
(a) Under numerical control?
(b) Are the numbers accounted for?

12. Are irregular discounts specifically approved by a responsible official?

13. Is approval of a responsible official a prerequisite to payment of customer credit balances?

14. Are the duties of the accounts receivable bookkeeper separate from all cash functions?

15. If there is more than one accounts receivable bookkeeper are the account sections for which they are responsible changed from time to time?

20. Is the collection department independent of and does it constitute a check on accounts receivable bookkeepers?

21. Is the management of the credit department completely divorced from:
(a) The sales department?
(b) The accounts receivable department?
(c) The cashier's department?

22. Is proper control exercised over recoveries on bad debts previously written off?

INVENTORIES

1. Are perpetual inventory records (or the equivalent such as job-orders) maintained with respect to the following classes of inventories:
(a) Raw materials?
(b) Supplies?
(c) Work in process?
(d) Finished stock?

2. Are all purchases of materials delivered to central stores (as opposed to direct delivery to production units)?

3. If so, are the stores records maintained by employees functionally independent of the stores keepers?

4. Are perpetual inventory records checked by:
   (a) Complete physical inventories at least once a year?
   (b) Periodical physical tests to the end that each class of inventory is counted at least once a year?

5. Is there written approval by a responsible employee of all adjustments:
   (a) To perpetual inventory records?
   (b) To controlling accounts?

6. Does system include provision for periodical reporting to responsible employee of:
   (a) Slow-moving items?
   (b) Obsolete items?
   (c) Overstocks?
   (d) Damaged items?

7. Are the following classes of inventories under accounting control:
   (a) Consignments-out?
   (b) Materials in hands of suppliers, processors, etc.?
   (c) Materials or merchandise in warehouses?
   (d) Merchandise shipped on memorandum?
   (e) Returnable containers?

8. Is merchandise on hand which is not the property of client (customers' merchandise, consignments-in, etc.):
   (a) Physically segregated if necessary?
   (b) Under accounting control?

9. As to physical inventories:
   (a) Are adequate written instructions prepared for guidance of participating employees including:
      (1) Proper identification and description of stock by personnel familiar therewith?
      (2) Check of counts by personnel independent of those maintaining perpetual records?
      (3) Control of inventory tags?
      (4) Cut-off of receipts and deliveries?
      (5) Good physical arrangement of stock?
      (6) Segregation of slow-moving, obsolete, and damaged items?
   (b) Are the following clerical steps independently checked:
      (1) Summarization of quantities?
      (2) Unit conversions?
      (3) Prices used?

(4) Extensions?
(5) Additions?
(6) Summarizations of cards or detailed sheets?

20. As to a cost system:
   (a) Is one in effect?
   (b) Is it tied in with the accounts?
   (c) Does it result in a reasonable determination of cost for inventory valuation purposes?

21. Is there effective control over items charged off but physically on hand, such as expense supplies, obsolete stock, etc.?

22. Does insurance coverage appear adequate?

23. Is there effective control over the accumulation and sale of scrap?

INVESTMENT SECURITIES

1. Are securities kept with an independent custodian, such as a bank or trust company?

2. Do transactions by the custodian require the authorization of more than one responsible official?

3. (a) If securities are not kept with a custodian, are they kept under lock and key?
   (b) Are they kept in a safe deposit vault?
   (c) Are they periodically inspected?
   (d) Is it necessary for more than one person to be present to open the box?
   (e) Are such persons independent of security record keeping?

4. Have registered securities been transferred to the name of the client?

5. If not, are they in negotiable form (endorsed in blank, in name of nominee of client or custodian, etc.)?

6. Is a record kept by the accounting department of each security, including certificate numbers?

7. Does the accounting department check to see that all income receivable is accounted for?

8. Are purchases and sales authorized by:
   (a) An officer?
   (b) The Board of Directors?

9. Are securities held for others or as collateral properly recorded and segregated?

10. Are securities which have been written off or for which a full reserve has been provided followed up as to possible realizability?

PROPERTY, PLANT AND EQUIPMENT

1. If the client constructs, or purchases and installs, substantial amounts of property additions by utilizing its own employees, are such expenditures controlled by the same routines as those controlling operating expenditures through:
   (a) Pay rolls?
   (b) Vouchers?
2. Are detailed plant records maintained in support of the general ledger control account?
3. Are such records balanced at least annually with general ledger control account?
4. As to additions to plant accounts:
   (a) Are they initiated by appropriation, order, or requisition showing:
      (1) Necessity for expenditures?
      (2) Estimated cost?
      (3) Description and proposed disposition of plant to be displaced, if any?
      (4) Detail plant accounts to be charged or credited?
   (b) Are such appropriations, orders, or requisitions approved by the Board of Directors or by person to whom Board has delegated such responsibility?
   (c) Are costs of additions accumulated and recorded by work order or job order?
   (d) If so, are actual costs later compared with the appropriations or authorized estimates?
   (e) If capital expenditures are not preauthorized, are actual expenditures approved by the Board of Directors or one or more responsible officials?
5. As to reductions in plant accounts:
   (a) Is written approval on a designated form required as a prerequisite to:
      (1) Sale of plant assets?
      (2) Dismantling of plant and sale of resulting scrap?
      (3) Transfers to other departments or units?
      (4) Is a copy of this form furnished to the accounting department?
6. Does the client:
   (a) Take periodical inventory of plant items for comparison with detail plant records?
   (b) Make periodical studies of properties for insurance purposes?

7. Are plant assets, fully depreciated, but still in use, carried in the property accounts?

20. Is a satisfactory system in effect for the safeguarding of small tools?

21. Does the client have a well-defined policy to govern accounting for capital additions as opposed to maintenance and repairs?

NOTES PAYABLE

1. Are borrowings authorized by Board of Directors?

2. Do the minutes of the Board of Directors specify:
   (a) The banks or other persons from whom funds may be borrowed?
   (b) The officers empowered to negotiate loans?
   (c) The maximum commitments such officers may make?

3. Is a note register or other subsidiary notes payable record kept which shows:
   (a) Principal amount?
   (b) Due dates—principal and interest?
   (c) Payments on principal?
   (d) Payments on interest?
   (e) Requirements under note agreement?

4. Is such detail record periodically reconciled with the control account?

5. Are paid notes properly canceled?

6. Are paid notes retained in the files?

ACCOUNTS PAYABLE

1. Is the aggregate of unpaid vouchers as indicated in the voucher register (or the aggregate of accounts payable balances) regularly reconciled with related general ledger control account?

2. Are statements from vendors regularly compared with recorded liabilities?

3. Are adjustments of recorded accounts payable required to be approved by a properly designated person?

4. Are debit balances of substantial amount approved and followed up by the credit department?

5 Is there an established procedure to insure that invoices are paid within discount dates?

CAPITAL STOCK AND LONG-TERM DEBT

1. Does the client employ:
   - (a) Independent transfer agent for:
     - (1) Common stock?
     - (2) Preferred stock?
     - (3) Long-term debt (registered securities)?
   - (b) Independent registrar for:
     - (1) Common stock?
     - (2) Preferred stock?
     - (3) Long-term debt?
2. If not:
   - (a) Are the following in custody of an officer:
     - (1) Unissued certificates and stock certificate stubs?
     - (2) Treasury shares?
     - (3) Unsigned bonds and long-term notes?
   - (b) Are the following prenumbered by the printer:
     - (1) Blank stock certificates and stubs?
     - (2) Unsigned bonds and long-term notes?
   - (c) Is the signing or countersigning in advance of stock certificates, bonds and long-term notes prohibited?
   - (d) Are surrendered certificates effectively canceled?
3. Does the client employ independent paying agents for:
   - (a) Dividends?
   - (b) Interest?

20. If the answer to Question 3 is "no,"
   - (a) Is proper control exercised in:
     - (1) Preparing, signing, and mailing:
       - Dividend checks?
       - Interest checks or coupons?
     - (2) Accounting for unclaimed:
       - Dividend checks?
       - Interest checks or coupons?
   - (b) Is the dividend bank account reconciled by someone other than persons maintaining the dividend records and mailing the checks?

SALES

1. Are customers' orders subjected to review and approval before acceptance:
   - (a) By sales or order department?

(b) By credit department?
(c) Are such orders prenumbered and the numbers accounted for?
(d) Are such orders correlated with sales invoices?

2. Are shipping advices prenumbered?
   (a) Are such numbers accounted for?
   (b) Are numbers issued correlated with sales invoices?

3. Are invoice, shipping advice, stock requisition, and packing slip prepared simultaneously?

4. Are invoices prenumbered?
   (a) If so are such numbers accounted for?
   (b) Are voided invoices kept and filed?

5. Are invoices checked for accuracy of:
   (a) Quantities billed?
   (b) Prices used?
   (c) Extensions?
   (d) Terms?

6. Are they compared with the customers' orders?

7. Are receiving reports prepared for all returned merchandise?
   (a) Are such receiving reports correlated with credit memoranda?

8. Are invoices summarized and classified by a department other than the accounting department in a manner to provide a check on recorded sales?

9. Are the following classes of sales cleared and recorded in the same manner as sales to customers:
   (a) Sales to employees?
   (b) Scrap and waste sales?
   (c) Sales of equipment?
   (d) C. O. D. sales?
   (e) Cash sales?

10. Can units of sales be correlated with purchases (or production) and inventories?
    (a) Are periodic reconcilements made with respect thereto?

20. Is there an adequate check on freight allowances?

PURCHASES AND EXPENSES

1. Does the client have a purchasing department? If so, is it divorced from:
   (a) The accounting function?

(b) The receiving function?
(c) The shipping function?

2. Are all purchases made on purchase orders?

3. Are the purchase orders prenumbered?
   (a) If so, are all numbers accounted for?

4. Does a copy of the purchase order go directly to the accounting department?
   (a) Is the accounting distribution entered on such purchase orders by the accounting department?

5. Does a copy of the receiving report go directly to the accounting department?

6. Are receiving tickets prenumbered?
   (a) If so, is a permanent record kept in the receiving department?
   (b) Is the sequence of numbers accounted for by the accounting department?

7. Are returned purchases cleared through the shipping department?
   (a) Are shipping advices prepared for such returns?
   (b) If so, are they correlated with vendors' credit advices?

8. Are invoices checked in the accounting department against:
   (a) Purchase orders?
   (b) Receiving reports?
   (c) Inspection reports?

9. Is there a definite (supported by evidence) responsibility for checking invoices as to:
   (a) Prices?
   (b) Extensions?
   (c) Freight charges?

10. Are invoices effectively marked to avoid duplicate payment?

11. Are purchases made for employees cleared through the purchasing department in a routine manner?

12. Are vouchers prepared for all purchase and expense items other than accruals?

13. Are distributions established by responsible employees?

14. Are distributions reviewed at or prior to the time vouchers are approved or paid?

15. Are vouchers for purchases and expenses examined by a responsible officer or employee to ascertain completeness of attachments and various required approvals?

16. Is postage metered?

PAY ROLLS

1. Are the various steps involved in the preparation of pay roll divided among a number of employees?
2. Are the duties of those preparing the pay roll rotated?
3. Are clerical operations in preparation of pay rolls double checked before payment?
4. Is time or piece-work record made on time clocks or by other means?
5. Are authorizations required for all:
   - (a) Changes in rates?
   - (b) Additions and
   - (c) Separations?
6. Are time or piece-work tickets or schedules checked to or compared with:
   - (a) Production schedules?
   - (b) Pay roll distribution?
7. Do foremen or timekeepers sign the weekly pay roll sheets?
8. Are employees paid by check?
9. If answer to Question 8 is "yes":
   - (a) Are the checks prenumbered?
   - (b) Are prenumbered checks which are spoiled or voided replaced by other prenumbered checks of the same series?
   - (c) Are voided checks:
     - (1) Retained and filed?
     - (2) Voided in a manner which precludes subsequent use?
   - (d) Are blank pay roll checks kept under adequate control?
   - (e) Is a check protector used?
   - (f) Where a mechanical check signer is used, is the operation of the machine under sole control of the authorized user?
10. Are pay roll checks signed by and returned for distribution to employees who do not participate in:
    - (a) The preparation of the pay roll?
    - (b) Custodianship of cash funds?
    - (c) Maintenance of accounting records?
11. Are pay roll disbursements made from an imprest bank account restricted to that purpose?
12. Are checks written on machines with automatic totals?
13. Where pay roll is paid in cash:
    - (a) Are receipts obtained from employees?

(b) Are such receipts compared with pay rolls by persons independent of the pay roll department?

14. Does client have an independent pay agent (for example, armored car or other service)?

15. If not:
   (a) Are paymasters rotated at varying intervals?
   (b) Are paymasters' functions independent of pay roll preparation?
   (c) Are paymasters' functions independent of other cash functions?
   (d) Is the paymaster accompanied by a person who has nothing to do with the preparation of pay roll?

16. Are salary rolls and special pay roll items (i.e., advances, etc.) subjected to the same critical routine as regular payments?

17. (a) Are reconciliations of pay roll bank accounts made each month?
   (b) Are they made by employees whose duties are unrelated to the pay roll department or the issuance and signing of pay roll checks?
   (c) Do such employees receive statements and canceled checks direct from the bank?

18. Does procedure followed when reconciling pay roll bank accounts include:
   (a) The checking of dates and names on pay roll checks against pay roll records?
   (b) The examination of endorsements on checks?

19. Are pay roll audits made periodically by:
   (a) The internal auditor?
   (b) Someone independent of all pay roll functions?

20. Is proper control exercised over:
   (a) Funds obtained for cash pay rolls?
   (b) Back pay?
   (c) Unclaimed wages?
   (d) Deductions from pay rolls?
   (e) Old outstanding checks?

GENERAL

1. Do our records include an up-to-date chart of client's organization?

2. Are officers' and employees' duties reasonably fixed as to responsibility?

3. Are accounting manuals in use?

4. Is the accounting department function completely divorced from:
   - (a) Selling?
   - (b) Manufacturing?
   - (c) Purchasing?
   - (d) Cash receipts?
   - (e) Cash disbursements?
   - (f) Insurance?
   - (g) Credit department?
5. Does the client have:
   - (a) A controller or someone acting in that capacity?
   - (b) An internal auditor or someone acting in that capacity?
6. Does the internal auditor:
   - (a) Follow written programs?
   - (b) Are such programs designed to test internal control?
   - (c) Does he issue reports covering his examinations?
7. Are accounting employees' duties rotated?
8. Are all employees required to take vacations?
9. Are all employees in positions of trust bonded?
10. Are the amounts and character of the bonds, as listed in our working papers, apparently adequate?
11. Are known relatives so employed as to make collusion improbable?
12. Are the books of account apparently:
    - (a) Adequate for the business?
    - (b) Kept up to date?
    - (c) Balanced at least monthly?
13. Do internal reports to the operating management appear to be adequate to bring to light abnormal financial figures and other discrepancies?
14. Are expenses and costs under budgetary control?
15. Does some responsible employee periodically review the adequacy of insurance coverage, particularly with respect to:
    - (a) Fire insurance, as regards:
      - (1) Inventories?
      - (2) Property, plant and equipment?
    - (b) Use and occupancy insurance?
    - (c) Public liability insurance?
    - (d) Workmen's compensation insurance?
16. Are journal vouchers approved by a responsible employee?
17. Are journal vouchers or entries in journal adequately explained or supported by substantiating data?

18. Does accounting control exercised over branch operations appear to be adequate?

19. If any of the officials are also executives of other business enterprises (other than known affiliates) with which the client does business:
    (a) Are transactions with such enterprises subject to the same routines as are those with regular vendors and customers?
    (b) Are duties of those officials such that irregular transactions are improbable?

20. Are all bank accounts in the name of the client or in the name of employees' associations (or other employee or company sponsored activities) for which the company is responsible recorded on the books?

ELECTRIC, GAS, AND WATER PUBLIC UTILITY COMPANIES

WORKING FUNDS

1. Is the imprest fund system used?
2. Is primary responsibility for each fund vested in only one person?
3. Are petty cash vouchers:
   - (a) Required for all disbursements from the fund?
   - (b) Prenumbered?
   - (c) Signed by the recipient of the funds disbursed?
   - (d) Executed in ink or otherwise to make alterations difficult?
   - (e) As to amounts, spelled out as well as written in numerals?
   - (f) Approved by a responsible official?
   - (g) Canceled, together with supporting documents, so that they cannot be misused thereafter?
4. Are checks for reimbursement made out to the order of the custodian?
   - (a) If not, specify.
5. Are funds audited by frequent and surprise counts by an internal auditor or other independent person?
6. If imprest fund is represented in whole or in part by bank account, has bank been notified that no checks payable to the company should be accepted for deposit?
7. Are funds limited to:
   - (a) A reasonable amount?
   - (b) Expenditures of a petty nature?
   - (c) Expenditures not exceeding a fixed amount?

20. Are the regular duties of the custodian of such a nature as would not necessitate his having access to:
    - (a) Remittances and other deposits?
    - (b) General accounting records?
21. Is there an adequate internal audit of reimbursement vouchers and attachments?
22. If custodian is authorized to cash checks:
    - (a) Is approval of someone other than the custodian required before checks may be cashed?

(b) Are all cashed checks deposited or cashed at the bank *without delay*?

CASH RECEIPTS

1. Are cash and collection stubs received by each cashier:
   (a) Segregated from those of other cashiers until delivered to person who prepares bank deposits?
   (b) Balanced by each cashier prior to delivery to person who prepares bank deposits?

2. Are bank deposits prepared by persons other than cashiers?
   (a) Do such persons determine that cashiers have balanced receipts with collection stubs prior to preparing the deposit?

3. Does the person responsible for making up the deposit:
   (a) Turn over such receipts to another employee who deposits cash in the bank?
   (b) If so, are the duties of such other employee of a nature that would not necessitate his having access to:
      (1) Customers' accounts receivable ledgers?
      (2) Customers' bills?

4. Are each day's receipts:
   (a) Recorded on the books when received?
   (b) Deposited intact and without delay?

5. Is a duplicate deposit ticket, after authentication by the bank, received by an employee who is independent of:
   (a) Person directly responsible for making up the deposit?
   (b) Employee who deposits cash in the bank?

   Are such deposit tickets checked with the aggregate amounts credited to accounts receivable and other accounts?

6. If customers mail payments to company:
   (a) Is the mail opened by an employee independent of persons directly responsible for:
      (1) Making up the cash deposit?
      (2) Posting customers' accounts receivable ledgers?
   (b) Is a detailed record of receipts prepared by the employee who opens the mail?
   (c) Is such record used by someone other than employees directly responsible for making up the deposit and posting customers' accounts receivable ledgers to verify amounts recorded and deposited?

7. Does each collection stub indicate date cash was received?

8. When partial payment is received, are cashiers and collectors required to note in ink (or with indelible stamp) that partial payment has been made and the amount of such payment on the:
   (a) Collection stub?
   (b) Customer's receipt (usually portion of original bill)?

9. Are deposit or collection items which are charged back by the bank as uncollectible delivered directly to an employee other than the person directly responsible for making up the deposit?

10. If deposit or collection items which are determined by the bank to be uncollectible are "redeemed" by the company instead of being charged back by the bank, are the duties of the employee who makes the "redemptions" independent of:
   (a) Cash receipts functions?
   (b) Customers' accounts receivable ledgers?
   (c) Customers' bills?

11. Are post-dated checks:
   (a) Held in safekeeping until deposited?
   (b) Recorded on the books when received?

12. Are other deficient remittances from customers:
   (a) Deposited promptly?
   (b) If not, are they:
      (1) Held in safekeeping?
      (2) Recorded on the books when received?
   (c) Referred to credit manager or other designated employee for investigation and settlement?

13. Where district offices make collections:
   (a) Are such collections deposited locally in a bank account subject only to home office withdrawal?
   (b) If so:
      (1) Are duplicate deposit slips, authenticated by bank, mailed directly by bank to home office?
      (2) Are such duplicate deposit slips compared in detail with advices from district office?
   (c) Are monthly statements mailed directly to the home office by such bank?

14. Are negotiable assets, other than currency, checks or drafts in custody of an employee independent of persons directly responsible for cash receipts?

15. Are all bank accounts authorized by Board of Directors?

20. Are duties of person who makes up the deposit of such a nature that it is unnecessary for him to have access to:
    (a) Customers' accounts and notes receivable ledgers?
    (b) Customers' bills?

CASH DISBURSEMENTS
(excluding pay roll disbursements)

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1. Are checks used for following purposes prenumbered by printer:
    (a) Regular cash disbursements?
    (b) Others—specify (e.g., dividend disbursements, etc.):
        (1)
        (2)
        (3)
2. Are prenumbered checks which have been spoiled and voided replaced by other prenumbered checks of the same series?
3. Is supply of unused checks under adequate control?
4. Are spoiled checks:
    (a) Retained and filed?
    (b) Voided in a manner which precludes subsequent use?
5. Is a check protector used?
6. Is the practice of countersigning checks followed in respect to checks drawn for:
    (a) Regular cash disbursements?
    (b) Others (specify):
        (1)
        (2)
        (3)
7. Must one of the signatures on each check be that of an employee whose duties do not include:
    (a) Posting accounting records?
    (b) Recording cash receipts?
    (c) Handling petty cash funds?
    (d) Approving vouchers for payment?
8. Are checks mailed by an employee whose duties do not include:
    (a) Posting accounting records?
    (b) Recording cash receipts?
    (c) Handling petty cash funds?
    (d) Approving vouchers for payment?

9. Is the signing or countersigning of blank checks prohibited?

10. Where a mechanical check signer is used:
    - (a) Is the operation of the signature machine under control of the authorized user?
    - (b) Does such authorized user qualify under Question 7?

11. Is the practice of drawing checks to "cash" prohibited?

12. Are transfers from one bank to another promptly recorded?

13. Does supporting data accompany checks when they are submitted for:
    - (a) Signature?
    - (b) Countersignature?

14. Is there evidence that supporting data has been examined by persons signing checks?

15. Are bank reconciliations made every month for:
    - (a) Regular bank accounts?
    - (b) List exceptions:
        - (1)
        - (2)
        - (3)

16. Are bank reconciliations made by employees whose duties do not involve the recording or handling of cash, including signing of checks?

17. Do the employees who are responsible for bank reconciliations receive unopened envelopes containing bank statements directly from the banks?

18. Do employees when reconciling bank accounts:
    - (a) Account for sequence of check numbers?
    - (b) Examine as to:
        - (1) Date?
        - (2) Payee's name?
        - (3) Bank cancellations?
        - (4) Endorsements?
        - (5) Authorized signatures?

19. Are inadequately endorsed checks paid by banks returned to such banks for proper endorsement?

20. Is there an adequate procedure for the control of old outstanding checks?

21. Are stop-payment notices and related entries under adequate accounting control?

NOTES RECEIVABLE

1. Are notes receivable (including renewal notes) approved by an officer or a designated employee prior to acceptance?
2. Is a detailed record of notes receivable maintained?
3. Is such record periodically balanced with the general ledger control account?
4. Are notes receivable endorsed for reductions when partial payments are made?
5. Is a record of discounted notes receivable kept so as to reflect the contingent liability?
6. Does the company periodically request customers to confirm unpaid balances of notes receivable?
7. Are unpaid balances of notes receivable periodically reviewed by an officer or a designated employee to ascertain delinquent amounts?
8. Does a responsible official approve the write-off of uncollectible balances of notes receivable?
9. Are the duties of the custodian of notes receivable of such a nature that it is unnecessary for him to have access to:
   (a) Cash records?
   (b) General books of company?
10. Is negotiable collateral in custody of an employee other than those who are responsible for:
    (a) Cash receipts?
    (b) Notes receivable record?
11. Are notes receivable and collateral kept with an independent custodian, such as a bank or trust company?
12 If not:
    (a) Are they kept under lock and key?
    (b) Are they kept in a safe deposit vault?
    (c) Are they periodically inspected?
    (d) Is it necessary for more than one person to be present to open the box?
    (e) Are such persons independent of notes receivable record keeping?

20. Is proper control exercised over recoveries on notes previously written off?

ACCOUNTS RECEIVABLE
(utility customers, appliance and miscellaneous)

1. Is the total of the individual accounts regularly balanced with the control?
2. Are the following classes of accounts aged periodically for review:
   (a) Utility customers?
   (b) Appliance?
   (c) Miscellaneous?
3. Are the following classes of delinquent accounts periodically reviewed by a responsible official:
   (a) Utility customers?
   (b) Appliance?
   (c) Miscellaneous?
4. Are delinquent notices:
   (a) Issued promptly?
   (b) Followed up properly?
5. Are final bills issued promptly?
   Is a special effort made to collect such bills?
6. Are bills sent to *all* customers on regular billing dates?
7. If not, are there some equivalent means of control?
8. Are the following classes of bills independently checked to accounts prior to being mailed:
   (a) Utility customers?
   (b) Appliance?
   (c) Miscellaneous?

   Are such bills kept under control to insure their being mailed by someone other than the accounts receivable bookkeepers:
   (a) Utility customers?
   (b) Appliance?
   (c) Miscellaneous?
9. Are accounts with customers confirmed by employees who are independent of the:
   (a) Cashiers?
   (b) Credit department employees?
   (c) Accounts receivable bookkeepers?
10. Are disputed items handled by employees other than the:
   (a) Cashiers?
   (b) Accounts receivable bookkeepers?

11. Does a responsible official approve:
    (a) Write-off of bad debts?
    (b) Adjustment credits?
12. Are credit memoranda:
    (a) Under numerical control?
    (b) Are the numbers accounted for?
13. Are irregular discounts specifically approved by a responsible official?
14. Is approval of a responsible official a prerequisite to payment of customer credit balances?
15. Are the duties of the accounts receivable bookkeeper separate from all cash functions?
16. If there is more than one accounts receivable bookkeeper are the account sections for which they are responsible changed from time to time?
17. Are repossession notices issued promptly? Are the terms of such notices enforced?
20. Is the collection department independent of and does it constitute a check on accounts receivable bookkeepers?
21. Is the management of the credit department completely divorced from:
    (a) The sales department?
    (b) The accounts receivable department?
    (c) The cashier's department?
22. Is proper control exercised over recoveries on bad debts previously written off?
23. Is a complete file of accounts written off maintained and checked against:
    (a) All applications for utility service?
    (b) All orders for sales of appliances?

MATERIALS, SUPPLIES, FUEL AND MERCHANDISE

1. Are perpetual inventory records maintained for:
    (a) Materials and supplies for construction and operation?
    (b) Fuel?
    (c) Merchandise?
2. Are all material purchases delivered to central stores (as opposed to direct delivery to construction or maintenance jobs)?

   If not, is receipt of materials and their use on the job subject to inventory control by the storekeeper?

3. Are the stores records maintained by employees functionally independent of the stores keepers?

4. Are perpetual inventory records checked by:
   (a) Complete physical inventories at least once a year?
   (b) Periodical physical tests to the end that each class of inventory is counted at least once a year?

5. As to physical inventories:
   (a) Are adequate written instructions prepared for guidance of participating employees including:
      (1) Proper identification and description of stock by personnel familiar therewith?
      (2) Check of counts by personnel independent of those maintaining perpetual records?
      (3) Control of inventory tags?
      (4) Cut-off of receipts and issues?
      (5) Good physical arrangement of stock?
      (6) Segregation of slow-moving, obsolete, and damaged items?
   (b) Are the following clerical steps independently checked:
      (1) Summarization of quantities?
      (2) Unit conversions?
      (3) Prices used?
      (4) Extensions?
      (5) Additions?
      (6) Summarizations of cards or detailed sheets?

6. Is there written approval by a responsible employee of all adjustments:
   (a) To perpetual inventory records?
   (b) To controlling accounts?

7. Does system include provision for periodical reporting to responsible employee of:
   (a) Slow-moving items?
   (b) Obsolete items?
   (c) Overstocks?
   (d) Damaged items?

8. Is merchandise on hand which is not the property of the company (consignments-in, etc.):
   (a) Physically segregated, if necessary?
   (b) Under accounting control?

20. Is there effective control over by-products obtained through gas production processes?

21. Is there effective control over items charged off but physically on hand (such as expense supplies) ?

22. Are reels, drums, and containers:
    (a) Properly accounted for?
    (b) Promptly returned for credit when empty?

23. Is there adequate control over materials and supplies returned to stores:
    (a) Unused, from construction and maintenance jobs?
    (b) Salvaged, from retirement jobs?

24. Is there effective control over the accumulation and sale of scrap?

25. Does insurance coverage appear adequate?

INVESTMENT SECURITIES

1. Are securities kept with an independent custodian, such as a bank or trust company?

2. Do transactions by the custodian require the authorization of more than one responsible official?

3. (a) If securities are not kept with a custodian, are they kept under lock and key?
   (b) Are they kept in a safe deposit vault?
   (c) Are they periodically inspected?
   (d) Is it necessary for more than one person to be present to open the box?
   (e) Are such persons independent of security record keeping?

4. Have registered securities been transferred to the name of the client?

5. If not, are they in negotiable form (endorsed in blank, in name of nominee of client or custodian, etc.) ?

6. Is a record kept by the accounting department of each security, including certificate numbers?

7. Does the accounting department check to see that all income receivable is accounted for?

8. Are purchases and sales authorized by:
    (a) An officer?
    (b) The Board of Directors?

9. Are securities held for others or as collateral properly recorded and segregated?

10. Are securities which have been written off or for which a full reserve has been provided followed up as to possible realizability?

PROPERTY, PLANT AND EQUIPMENT

1. Are property, plant and equipment accounts maintained in accordance with a uniform system of accounts prescribed by a regulatory commission?
2. If the company constructs, or purchases and installs, substantial amounts of property additions by utilizing its own employees, are such expenditures controlled by the same routines as those controlling operating expenditures through:
   (a) Pay rolls?
   (b) Vouchers?
3. Are detailed property records maintained in support of the general ledger control account?
4. Are such records balanced at least annually with general ledger control account?
5. As to additions to property accounts:
   (a) Are they initiated by authorization, work order, or requisition showing:
      (1) Necessity for expenditures?
      (2) Estimated cost?
      (3) Description and proposed disposition of property to be displaced, if any?
      (4) Detail property accounts to be charged or credited?
   (b) Are such authorizations, work orders, or requisitions approved by the Board of Directors or by person or group to whom Board has delegated such responsibility?
   (c) Are costs of additions accumulated and recorded by work order or job order?
   (d) If so, are actual costs later compared with the authorized estimates?
   (e) If capital expenditures are not preauthorized, are actual expenditures approved by the Board of Directors or one or more responsible officials?
6. As to retirements of property:
   (a) Is written approval on a designated form required as a prerequisite to:
      (1) Sale of property?
      (2) Dismantling of property and sale of resulting scrap?
      (3) Transfers to other departments or units?
      (4) Is a copy of this form furnished to the accounting department?

7. Does the company:
   (a) Take periodical inventories of property items for comparison with detailed records?
   (b) Make periodical studies of properties for insurance purposes?

8. Are items of property which have been fully depreciated, but which are still in use, carried in the property accounts?

9. Does company follow a definite policy with respect to capitalization of:
   (a) Overhead costs?
   (b) Interest during construction?

20. Is a satisfactory system in effect for the safeguarding of small tools?

21. Is salvage from retirements under adequate accounting control?

22. Does the company have a well-defined policy to govern accounting for capital additions as opposed to maintenance and repairs?

23. Is company's policy with respect to retirements properly established so that accounting department is advised promptly by engineering or construction departments as to property retired through replacement or abandonment?

24. Are preliminary survey and investigation charges and related construction charges applicable to abandoned projects written off immediately?

NOTES PAYABLE

1. Are borrowings authorized by Board of Directors?

2. Do the minutes of the Board of Directors specify:
   (a) The banks or other persons from whom funds may be borrowed?
   (b) The officers empowered to negotiate loans?
   (c) The maximum commitments such officers may make?

3. Where required, has permission to borrow been obtained from regulatory commissions having jurisdiction?

4. Is a note register or other subsidiary note payable record kept which shows:
   (a) Principal amount?
   (b) Due dates—principal and interest?
   (c) Payments on principal?
   (d) Payments on interest?
   (e) Requirements under note agreement?

5. Is such detail record periodically reconciled with the control account?

6. Are paid notes properly canceled?
7. Are paid notes retained in the files?

ACCOUNTS PAYABLE AND CUSTOMERS' DEPOSITS

1. Is the aggregate of unpaid vouchers, as indicated in the voucher register (or the aggregate of accounts payable balances), regularly reconciled with related general ledger control account?
2. Are statements from vendors regularly compared with recorded liabilities?
3. Are adjustments of recorded accounts payable required to be approved by properly designated persons?
4. Are debit balances of substantial amount approved and followed up by the credit department?
5. Is there an established procedure to insure that invoices are paid within discount dates?
6. Are separate detailed records and general ledger control accounts maintained for:
   (a) Active customers' deposits?
   (b) Unclaimed customers' deposits?
7. Are detailed customers' deposit records periodically balanced with related general ledger control accounts?
8. Are refunds of deposits to customers approved by properly designated persons?
9. In case of refunds, are original receipts, or affidavits of loss thereof, procured before refund is made?
10. Are deposits promptly applied against final bills?

CAPITAL STOCK AND LONG-TERM DEBT

1. Does the company employ an:
   (a) Independent transfer agent for:
      (1) Common stock?
      (2) Preferred stock?
      (3) Long-term debt (registered securities)?
   (b) Independent registrar for:
      (1) Common stock?
      (2) Preferred stock?
      (3) Long-term debt?

2. If not:
   - (a) Are the following in custody of an officer:
     - (1) Unissued certificates and stock certificate stubs?
     - (2) Treasury shares?
     - (3) Unsigned bonds and long-term notes?
   - (b) Are the following prenumbered by the printer:
     - (1) Blank stock certificates and stubs?
     - (2) Unsigned bonds and long-term notes?
   - (c) Is the signing or countersigning in advance of stock certificates, bonds, and long-term notes prohibited?
   - (d) Are surrendered certificates effectively canceled?

3. Does the company employ independent paying agents for:
   - (a) Dividends?
   - (b) Interest?

20. If the answer to Question 3 is "no":
   - (a) Is proper control exercised in:
     - (1) Preparing, signing and mailing:
       - Dividend checks?
       - Interest checks or coupons?
     - (2) Accounting for unclaimed:
       - Dividend checks?
       - Interest checks or coupons?
   - (b) Is the dividend bank account reconciled by someone other than persons maintaining the dividend records and mailing the checks?

REVENUES

1. Are applications for electric, gas, and other service subject to review and approval before acceptance by service or credit department?
2. Is company's procedure so arranged as to insure that all meter sheets in a route book are forwarded to billing department?
3. Are meter readers rotated periodically from one route to another?
4. Are meter readers prohibited from making collections?
5. Are duties of meter readers of such a nature that it is unnecessary for them to have access to accounts receivable records?
6. Are periodic bills checked for accuracy of electricity, gas, or water consumed; rates; extensions; etc. before being mailed to consumers?
7. Are service cut-offs approved by credit manager or other responsible employee?

8. Does company maintain meter history cards?
9. If so, are these cards periodically checked to customers' ledger and route sheets to see that a customer is being billed for each meter in service, that meter constants are correct, etc.?
10. Are all rates in effect covered by tariffs filed with the regulatory commission?

PURCHASES AND EXPENSES

1. Does the client have a purchasing department? If so, is it divorced from:
   (a) The accounting function?
   (b) The receiving function?
2. Are all purchases made on purchase orders?
3. Are the purchase orders prenumbered?
   (a) If so, are all numbers accounted for?
4. Does a copy of the purchase order go directly to the accounting department?
5. Does a copy of the receiving report go directly to the accounting department?
6. Are receiving tickets prenumbered?
   (a) If so, is a permanent record kept in the receiving department?
   (b) Is the sequence of numbers accounted for by the accounting department?
7. Are invoices checked in the accounting department against:
   (a) Purchase orders?
   (b) Receiving reports?
   (c) Inspection reports?
8. Is there a definite (supported by evidence) responsibility for checking invoices as to:
   (a) Prices?
   (b) Extensions?
   (c) Freight charges?
9. Are invoices effectively marked to avoid duplicate payment?
10. Are purchases made for employees cleared through the purchasing department in a routine manner?
11. Are vouchers prepared for all purchase and expense items other than accruals?
12. Are distributions established by responsible employees?

13. Are distributions reviewed at or prior to the time vouchers are approved or paid?
14. Are vouchers for purchases and expenses examined by a responsible officer or employee to ascertain completeness of attachments and various required approvals?
15. Is postage metered?
16. Is there adequate accounting control over returned purchases?

PAY ROLLS

1. Are the various steps involved in the preparation of the pay roll divided among a number of employees?
2. Are the duties of those preparing the pay roll rotated?
3. Are clerical operations in preparation of pay rolls double checked before payment?
4. Are authorizations required for all:
   (a) Changes in rates?
   (b) Additions?
   (c) Separations?
5. Are daily time reports:
   (a) Prepared by each employee engaged in construction and maintenance work?
   (b) Properly approved by foremen or other designated employees?
6. Do time reports contain sufficient description of activity to enable proper distributions to accounts?
7. Are employees paid by check?
8. If answer to Question 7 is "yes":
   (a) Are the checks prenumbered?
   (b) Are prenumbered checks which are spoiled or voided replaced by other prenumbered checks of the same series?
   (c) Are voided checks:
      (1) Retained and filed?
      (2) Voided in a manner which precludes subsequent use?
   (d) Are blank pay roll checks kept under adequate control?
   (e) Is a check protector used?
   (f) Where a mechanical check signer is used, is the operation of the machine under sole control of the authorized user?
9. Are pay roll checks signed by and returned for distribution to employees who do not participate in:
   (a) The preparation of the pay roll?

(b) Custodianship of cash funds?
(c) Maintenance of accounting records?

10. Are pay roll disbursements made from an imprest bank account restricted to that purpose?
11. Are checks written on machines with automatic totals?
12. Where pay roll is paid in cash:
    (a) Are receipts obtained from employees?
    (b) Are such receipts compared with pay rolls by persons independent of the pay roll department?
13. Does client have an independent pay agent (for example, armored car or other service)?
14. If not:
    (a) Are paymasters rotated at varying intervals?
    (b) Are paymasters' functions independent of pay roll preparation?
    (c) Are paymasters' functions independent of other cash functions?
    (d) Is the paymaster accompanied by a person who has nothing to do with the preparation of pay roll?
15. Are salary rolls and special pay roll items (i.e., advances, etc.) subjected to the same critical routine as regular payments?
16. (a) Are reconciliations of pay roll bank accounts made each month?
    (b) Are they made by employees whose duties are unrelated to the pay roll department or the issuance and signing of pay roll checks?
    (c) Do such employees receive statements and canceled checks direct from the bank?
17. Does procedure followed when reconciling pay roll bank accounts include:
    (a) The checking of dates and names on pay roll checks against pay roll records?
    (b) The examination of endorsements on checks?
18. Are pay roll audits made periodically by:
    (a) The internal auditor?
    (b) Someone independent of all pay roll functions?
20. Is proper control exercised over:
    (a) Funds obtained for cash pay rolls?
    (b) Back pay?
    (c) Unclaimed wages?
    (d) Deductions from pay rolls?
    (e) Old outstanding checks?

GENERAL

1. Do our records include an up-to-date chart of client's organization?
2. Are officers' and employees' duties reasonably fixed as to responsibility?
3. Are the accounts kept in accordance with the uniform system of accounts prescribed by the regulatory commission?
4. Are accounting manuals in use?
5. Is the accounting department function completely divorced from:
   (a) Selling (appliances)?
   (b) Purchasing?
   (c) Cash receipts?
   (d) Cash disbursements?
   (e) Insurance?
   (f) Credit department?
6. Does the client have:
   (a) A controller or someone acting in that capacity?
   (b) An internal auditor or someone acting in that capacity?
7. Does the internal auditor:
   (a) Follow written programs?
   (b) Are such programs designed to test internal control?
   (c) Does he issue reports covering his examinations?
8. Are accounting employees' duties rotated?
9. Are all employees required to take vacations?
10. Are all employees in positions of trust bonded?
11. Are the amounts and character of the bonds, as listed in our working papers, apparently adequate?
12. Are known relatives so employed as to make collusion improbable?
13. Are the books of account apparently:
    (a) Adequate for the business?
    (b) Kept up to date?
    (c) Balanced at least monthly?
14. Do internal reports to the operating management appear to be adequate to bring to light abnormal financial figures and other discrepancies?
15. Are expenses and construction costs under budgetary control?

16. Does some responsible employee periodically review the adequacy of insurance coverage, particularly with respect to:
    (a) Fire insurance?
    (b) Use and occupancy insurance?
    (c) Public liability insurance?
    (d) Workmen's compensation insurance?

17. Are journal vouchers approved by a responsible employee?

18. Are journal vouchers or entries in journal adequately explained or supported by substantiating data?

19. Does accounting control exercised over district offices appear to be adequate?

20. If any of the officials are also executives of other business enterprises (other than known affiliates) with which the client does business:
    (a) Are transactions with such enterprises subject to the same routines as are those with regular vendors and customers?
    (b) Are duties of those officials such that irregular transactions are improbable?

21. Are all bank accounts in the name of the company or in the name of employees' associations (or other employee or company sponsored activities) for which the company is responsible recorded on the books?

BANKS AND TRUST COMPANIES

TELLERS' CASH AND CASH ITEMS

1. Are the general ledger records and the individual depositors' ledgers inaccessible to the regular and relief tellers?
2. Does each teller have a separate cage or a partitioned space in which to work?
3. Are persons prohibited access to the tellers' cages while the regular tellers are on duty?
4. Are the tellers required to keep their cage doors locked?
5. Are tellers required to exchange funds at irregular intervals (i.e., teller No. 1 exchanges his fund with teller No. 2, etc.)?
6. Is the amount of each teller's cash fund kept as low as possible?
7. Is excess cash removed and deposited or placed under dual control in the vault or reserve cash?
8. If more than one teller operates from the same cage or section are they required to balance separately?
9. If there are separate receiving and paying tellers are settlements required from each teller?
10. Are relief tellers provided with a fund of their own?
11. Is the regular teller's cash locked securely during the time the relief teller is in attendance?
12. Is a proof of cash prepared by each teller?
13. Does the internal auditor or an executive officer:
    - (a) Make frequent surprise counts of the teller's cash and the reserve cash held in the vault?
    - (b) Count the cash of tellers when they are leaving for vacations, etc.?
14. Is some person not having access to cash designated to keep a record of all cash items and "hold over" items and see that they are cleared and properly settled?
    Does the internal auditor or an executive officer review the cash item record daily?
15. Are returned checks and other items routed to someone other than to the teller who first received them?

16. Are returned items charged immediately to the depositors' accounts and advices mailed to the depositor by someone not having access to the cash?

17. Are differences cleared daily to an "over and short" account in the general ledger?

18. Is a report of the differences by tellers submitted to an officer for review?

19. Are tellers forbidden to cash checks for themselves and to make deposits for their own account?

20. Are tellers forbidden to maintain a "kitty" for covering small differences?

21. Is the certification stamp locked up at night?

22. Is special authority given to certain employees to certify checks?

COLLECTION ITEMS

1. Does the auditor or an officer review the open items in cash collection account at least monthly and determine that all are current?

2. Are employees in charge of collections rotated or changed at frequent intervals without prior notice?

3. (Applicable only to departments having a cash fund or receiving cash.)
   (a) Does the internal auditing department periodically prove the open collections by listing the items by collecting banks, cross-checking to files by customers, and further verifying receipt of remittance, credit, or return, or examination of local collections on hand?
   (b) Are items which are unaccounted for traced to final disposition?

4. Are tracers received from other banks routed to the auditing department for attention and checking out?

DUE FROM BANKS

1. Is the reconciliation made by:
   (a) Someone other than the general ledger bookkeeper,
   (b) The person who prepares the drafts drawn against the account, or
   (c) The person who signs them?

2. Does the auditor, or an officer who does not handle cash, check the reconciliations at least monthly and ascertain that all reconciling items are proper and are satisfactorily cleared?
3. Are blank drafts kept in the custody of a person with instructions to deliver a new supply in consecutive numerical order and only upon approval of a proper officer?
4. Are the drafts issued by one person, recorded by another, and signed by an officer?
5. Are voided drafts kept and filed?
6. Is the sequence of draft numbers accounted for by whoever reconciles bank balances?
7. Is a draft register prepared simultaneously with the preparation of the draft by mechanical device?
8. Are authorized signatures limited to employees who have no access to accounting records?
9. Is the signing or countersigning of drafts in advance prohibited?
10. Are transfers from one bank to another under accounting control?
11. Is the practice of examining paid drafts for date, name, cancellations, and endorsements followed by those reconciling bank accounts?
12. Are vouchers and supporting data effectively canceled to prevent subsequent misuse?
13. Are protectograph machines kept under adequate control?

LOANS

1. Is the officer required to initial each loan or renewal he makes?
2. Does some person check the loans made the day before against the note register and see that the initials of the loan officer or officers appear (in ink) on the note?
3. (a) Is the note register, against which the notes have been checked, submitted to members of the Loan Committee for review and approval?
   (b) If schedule of loans made or renewed is submitted to the Loan Committee, is it verified by someone other than a loan department employee?
4. Does the internal auditing department or some designated person not connected with the loan cage keep an independent tickler of all loans?

5. Is it the practice for someone not connected with the loaning function to communicate with each borrower after the loan is made, i.e., send out a notice to each borrower giving him the details of the loan and the collateral, if any, which has been deposited?

6. Are loans confirmed periodically by direct correspondence with the borrowers?

7. Are all new loans submitted for inspection to some person other than the loan officer?

8. Are machine tape listings prepared of the notes and trial balance of liability ledger or note tickler prepared at frequent intervals?

9. Are the trial balances prepared by someone not connected with the loan cage?

10. Are the notes out for collection, etc., subsequently:
    (a) Confirmed by correspondence or
    (b) The remittances received checked against the trial balance?

11. Is it required to return the expired note to the borrower?

12. Is a list of past due paper prepared at frequent intervals and submitted to:
    (a) An executive officer?
    (b) The Loan Committee?

13. Does someone independent of the loan department check the loan records to see that the accruals of interest and unearned discount are correct and in agreement with the general ledger controls?

14. If tellers prepare bills for interest are they mailed by someone else?

15. Are there proper controls in the general ledger for interest billed?

16. Is someone assigned to follow up delinquent interest collections?

17. Are accommodation endorsers advised by mail of the making of a loan by the bank?

18. Are demand loans allowed to run only for limited periods?

19. Are proper approvals obtained for authority to charge off loans?

20. Is it the practice of the bank to charge off loans in whole or in part and still keep them current by obtaining renewal notes, partial payments, and interest?

21. Is an adequate control maintained for such items?

22. Are these loans confirmed periodically by direct communication with the borrowers?

LOAN COLLATERAL

1. Is the record work on collateral done by
   (a) The note teller in his cage?
   (b) A person outside the cage using as posting media the record of vault deposits and withdrawals?
2. Is it required that two persons be in attendance when loan collateral is deposited in the vault or removed therefrom?
3. Does someone independent of the loan cage review the pricing of the collateral and see that adequate margin is maintained?
4. Are substitutions of collateral approved by an officer?
5. Does a responsible person review the collateral to determine whether the bank has a proper and realizable lien?
6. Is the approval of an officer required for temporary removals?
7. If the bank retains collateral on paid notes is the collateral removed to the safekeeping vault or file with notice to that effect to borrower?
8. Does someone review the collateral file to see that as the amounts of collateral notes are collected the customer has signed for the collateral returned to him, or that it has been transferred to safekeeping under proper control?
9. Is a tickler maintained for the collection of income from collateral?

BANK-OWNED INVESTMENTS

1. Are the bank-owned investments under adequate control, and can access be had only jointly by at least two employees, one of whom is an officer?
2. Are two official signatures required for the withdrawal of investment securities held by other banks for safekeeping or under depositary agreements?
3. Are investments in the name of the bank?
4. Is a record kept by the accounting department of each investment (including certificate numbers of securities)?
5. In larger banks is the unit control or similar means of control used? If so:
   (a) Is a control kept by the auditor?
   (b) Are the controlling records kept by the auditor?
   (c) Are postings to the records made from tickets forwarded to the auditor directly from the departments in which investment transactions originate?

(d) Are frequent counts of the investments made and the results compared with the control?

6. Are investment transactions approved by the proper officer and/or committee of the bank?
7. Are the purchases and sales of investments recorded in the minutes of the committee?
8. Are securities presently considered to be "worthless" or of nominal value, but which may have potential value, under accounting control?
9. Are securities mentioned above periodically checked against available statistical data to ascertain whether or not they have become of any value?
10. Is some person not connected with the security department advised of the withdrawal of all securities, and
11. Is it his duty to trace the transactions through until completed, i.e., until proceeds of the sale have been received; a receipt from the safekeeper (if being transferred to safekeeping); a receipt from the bank or person to whom the securities have been delivered, etc.?
12. Are general ledger accounts established to control the purchase and sale of securities, including open transactions?
13. Are bills and statements from brokers periodically checked against the control records?
14. Are controls maintained in the general ledger for accruals of income?
15. Are the details underlying the controls checked at frequent intervals to see that accruals are accurate and income due is collected?
16. Are mortgage investments handled through attorneys?
17. Does someone independent of the mortgage teller obtain the interest bills and check them?
18. Is someone assigned to check:
    (a) Payment of taxes and special assessments by mortgagors?
    (b) Maintenance of sufficient insurance properly assigned to the bank?
    (c) Periodic reappraisal of all mortgaged properties?
19. Are transactions in real estate authorized in the minutes of the bank's committees?
20. Does the internal auditor or someone not handling real estate transactions ascertain that proper entries have been made for the sale of property and that adjustments have been made in the expense accounts for refunds of insurance, taxes, and other items allowed in the settlement?

21. Is the operation of the property managed by:
    (a) The real estate department of the bank?
    (b) By independent real estate agents?

22. Are procedures established to follow up rent collections and delinquent rents?

LETTERS OF CREDIT AND ACCEPTANCES

1. Are the letter forms (unused stationery) kept under dual control and issued only upon properly approved requisitions?

2. Is a register maintained for unused letter forms and for those issued?

3. Do commercial letters of credit require upon issuance the signature of two officers and their initials on the bank's copy?

4. Is the function of issuing the Travelers' Letters separated from that of receiving cash for the letters?

5. When a draft is submitted for acceptance is a form prepared showing thereon all essential data?

6. If so, is this form, together with the draft for acceptance, submitted to the authorized officer for signature?

7. Does the internal auditor or someone designated for the purpose:
    (a) periodically inventory the unused letter forms,
    (b) check them with the control records,
    (c) prove the letter of credit and acceptance records?

8. Is control of documents (i.e., bills of lading, warehouse receipts, etc.) checked by internal auditors?

9. Do internal auditors confirm warehouse receipts by correspondence?

10. Is the customer's liability under letters of credit verified by correspondence with the customers?

DUE TO BANKS

1. Does the bookkeeper in charge of these accounts mail statements periodically?

2. Does the bookkeeper give the statements to some designated person (preferably the internal auditor) for mailing? If so, does that person check the balances as shown on the statements with the ledger accounts?

3. (a) Are copies of the reconciliation requested by the internal auditor and received by him from the correspondent bank?
    (b) Are reconciling items cleared by the internal auditor?

4. If copies of reconciliations have been requested but not received, are further requests made?

CHECKING DEPOSITS

1. Does someone besides the teller review the deposit tickets to ascertain that the tickets put through the current day's work do not bear some previous date?
2. Are the following inaccessible to the tellers:
   (a) The books of account?
   (b) The statement of the depositor's account?
3. (a) Are statements on which "Hold" instructions have been received delivered directly to the depositor by the bookkeeping department?
   (b) Has the bookkeeping department been instructed not to deliver such statements to officers or employees?
4. Is the officer opening a new account required to initial the signature cards for identification purposes?
5. Is the custody of the signature file under control of the head bookkeeper?
6. Are trial balances of the depositors' ledgers prepared by someone other than the bookkeeper?
7. Are trial balances prepared at least monthly?
8. Are statements mailed to:
   (a) All depositors at monthly intervals, or to
   (b) Active business accounts only?
9. Does the internal auditor or someone designated for the purpose:
   (a) Compare the statements with the ledger accounts, and
   (b) Mail them?
10. Does the auditor obtain confirmations directly from the depositor?
11. Are depositors' complaints regarding their statements directed to an officer?
12. Are separate ledgers and controls maintained for inactive or dormant accounts?
13. If the answer to Question 12 is "yes" does an officer authorize transferring an account from the active to the inactive ledger?
14. Are signature cards for all inactive accounts held by an officer?
15. Does this officer initial all checks drawn on these accounts?

16. Have the bookkeepers been instructed not to charge any check to these accounts unless it bears the officer's initials?
17. Does an officer make a periodic review of the inactive or dormant ledger accounts?
18. Are statements mailed on inactive accounts each time there is a transaction?
19. Does an officer inspect the accounts of employees at periodic intervals?
20. Are lists of all accounts closed during each day prepared and submitted to an officer for approval and communication directly with the depositor?

OFFICIAL AND CASHIER'S CHECKS

1. Are the official check forms:
   (a) Of a distinctive type?
   (b) Numbered consecutively by the printer?
2. Are the blank check forms under effective control?
3. Are all numbers accounted for at frequent intervals?
4. Are checks to be issued signed only by the authorized officer?
5. Is the signing of checks in blank by officers prohibited?
6. Are checks promptly canceled when paid?
7. Does the auditing department prove the control?

CERTIFICATES OF DEPOSIT

1. Are all certificate of deposit forms numbered consecutively by the printer?
2. Are blank certificate of deposit forms kept under proper control?
3. At the time a certificate is to be issued:
   (a) Is the certificate prepared and registered by someone other than the authorized signer?
   (b) Does the authorized signer initial the stub or register to indicate comparison of the amounts?
4. Are certificates promptly canceled when paid?
5. Are canceled certificates preserved in order to account for continuity of numbers?
6. Is the amount of interest on certificates of deposit verified before payment is made to depositor?
7. Does the auditing department prove the control?

CAPITAL STOCK

1. Does client employ independent registrar and transfer agents?
2. If not:
   (a) Are unissued certificates and stock certificate stubs in custody of an officer?
   (b) Are at least two persons required to participate in the issuance of stock certificates?
3. Are surrendered certificates canceled effectively?
4. Does the client employ independent dividend paying agents?
5. Is proper control exercised in preparing, mailing and accounting for unclaimed dividend checks?

PAY ROLLS

1. Is preparation of pay roll distributed among a number of employees?
2. Are the duties of those preparing the pay roll rotated?
3. Are clerical operations in preparation of pay rolls double checked before payment?
4. Are all changes in rates, additions, and dismissals authorized?
5. Are employees paid by check?
6. Are pay roll checks signed by employees who do not participate in:
   (a) The preparation of the pay roll?
   (b) Custodianship of cash funds?
   (c) Maintenance of accounting records?
7. Are pay roll disbursements made from an imprest bank account restricted to that purpose?
8. Are checks written on machines with automatic totals?
9. Are receipts obtained from employees?
10. Are employees who pay off rotated at regular intervals?
11. Are functions of employees (in Question 10) independent of pay roll preparation?
12. Are salary advances to officers, employees, etc., subjected to the same critical routine as regular employee salary payments?
13. Are reconciliations of pay roll bank accounts made by employees whose duties are unrelated to the pay roll department?

14. Does procedure followed when reconciling pay roll bank accounts include the checking of names on pay roll checks against pay roll records and the examination of endorsements on checks?

GENERAL

1. Do our records include a chart of client's organization?
2. Is it up to date?
3. Are officers' and employees' duties reasonably fixed as to responsibility?
4. Are accounting manuals in use?
5. Does the client have:
   (a) A controller?
   (b) An internal auditor?
6. Do we review:
   (a) The program of the internal auditor?
   (b) The reports of the internal auditor?
7. Are employees' duties rotated?
8. Are all employees required to take vacations?
9. Are all employees bonded?
10. Do the amounts of the bonds appear adequate?
11. Are known relatives so employed as to make collusion improbable?
12. Are the books of account apparently:
    (a) Adequate for the institution?
    (b) Kept up to date?
    (c) Balanced daily?
13. Do internal reports to the management appear to be adequate to bring to light abnormal financial figures and other discrepancies?
14. Are expenses under budgetary control?
15. Does some responsible employee periodically review insurance coverage?
16. Are journal vouchers approved by a responsible official?
17. Are journal vouchers or entries in journal adequately explained or supported by substantiating data?
18. Does accounting control exercised over branch operations appear to be adequate?
19. Are vouchers prepared for all purchase and expense items?

20. Are distributions of expenses established by responsible employees prior to time vouchers are approved or paid?

21. Are vouchers for purchases and expenses examined by an officer or employee to ascertain completeness of attachments and required approvals?

22. Is postage metered?

23. Is adequate control maintained over incoming registered mail?

SAFEKEEPING DEPARTMENT

1. Is there a special vault maintained for safekeeping?

2. Is the vault of modern construction and protected by Holmes Electric Protective Service or some such alarm and protective system?

3. Are sufficient guards in attendance during the time the vault is open, in accordance with the terms of the insurance policy?

4. Is the vault in the custody of employees especially designated for the purpose?

5. Is an officer or officers required to open the vault at the start of the day and also close it at the end of the day?

6. Are two or more persons required to be in attendance when items are deposited in, or withdrawn from, the vault?

7. Are formal receipt and withdrawal tickets required for all items deposited in, or withdrawn from, safekeeping?

8. Are customers required to sign the vault ticket when depositing and withdrawing items from safekeeping?

9. Is the vault custodian in attendance required to initial the vault tickets at the time items are deposited and withdrawn from the vault?

10. Are acknowledgments of items received and withdrawn from safekeeping mailed to customers?

11. Are deliveries made only upon presentation of the original receipt?

12. Are statements of customers' accounts and requests for confirmation prepared by the accounting department independent of the vault custodians?

13. Are replies from customers routed:
    (a) Directly to the internal auditor, or
    (b) To someone else not working in the vault or on the vault records?

14. Does the auditing department maintain control records of the vault?

15. Does the auditing department make frequent surprise counts of the vault and reconcile the count with the control records?

16. Are adequate records maintained to control powers of attorney, coupons, etc.?

17. If the bank clips the coupons, is the process under control of two or more persons whose duties are divorced from record keeping?

18. Is a record of amounts and details established before the coupons are clipped?

19. If so:
 (a) Is this list given to the collection department for the purpose of checking the coupons as they are turned in, and
 (b) A copy of the list given to the auditing department for audit purposes?

PERSONAL TRUST DEPARTMENT

1. Upon receipt of a new account, does an officer:
 (a) Review the instrument under which the bank is appointed?
 (b) Ascertain that all papers are in order?
 (c) Prepare an abstract or docket record showing:
  (1) Title of account, including capacity?
  (2) Provisions of will or deed of trust, etc.?
  (3) Available information regarding beneficiaries?
  (4) Fee basis and when collectible?

2. Is it required:
 (a) That at least two persons, including a representative of the auditing department be present when assets are received, and
 (b) That the auditor obtain copy of listing of assets to trace subsequent deposit in vault?

3. Is an effective dual control of securities maintained by:
 (a) Auditing department holding pass key or one combination?
 (b) Requiring two trust department officers to be present when securities are deposited or withdrawn?
 (c) Listing all deposits or withdrawals on vault tickets, one copy of which is used by auditing department and transaction traced?
 (d) Listing all deposits or withdrawals in vault book which is used by someone other than those having access to vault for tracing securities?

4. Is auditing department or an individual without access to cash or securities responsible for listing securities purchased per cash book and ascertaining that they are properly deposited in the vault?

5. Is there an adequate control over securities temporarily withdrawn from the vault for exchange or transfer?

6. Are investment records, trust estate ledgers, and income records controlled so that vault custodian has no access to them?

7. Does the trust investment committee authorize all purchases and sales of securities before the orders are given to brokers?

8. Does the auditing department mail requests for confirmation to the parties at interest and obtain replies on all securities added to accounts by the trustor, etc., and securities delivered "free"?

9. Are investments periodically reviewed to ascertain that they conform to the terms of the trust?

10. Are statements of principal and income transactions regularly mailed to the parties at interest?

11. Is the collection of coupons and dividends controlled by:
    (a) The auditing department ascertaining only that the aggregate income receivable from each issue of securities is recorded in the cash receipts record?
    (b) The auditing department tracing the credits to the individual trust accounts?
    (c) The statement clerks ascertaining that income is properly credited when statements are prepared?

12. Is the function of billing mortgage interest and principal and real estate rentals segregated from the collection thereof?

13. Are distributions of principal and income cash and of securities authorized in writing by officers?

14. Are the same procedures as outlined in answers to Questions 19 to 28 under bank-owned investments followed in connection with trust real estate?

15. Is a record maintained of all principal and income overdrafts and submitted to an officer and the Trust Committee?

16. Are settlement and departmental proof sheets prepared daily showing all or a summary of transactions of the department?

17. Does the auditing department or someone designated for the purpose make periodic checks of the accounts to see that fees are being collected?

CORPORATE TRUST DEPARTMENT

1. Is an adequate docket maintained?
2. Is it required that a representative of the auditing department be present when collateral and unissued bonds are received?
3. Is an effective dual control maintained of all collateral and securities, including unissued, uncertified, certified, and canceled bonds?
4. Is it required that a senior officer approve substitutions of collateral and that the substituted collateral be received and inspected before delivery is made of the collateral withdrawn?
5. Does the auditing department inspect all bonds redeemed and compare the total with the disbursement therefor?
6. Are payments of coupons verified by:
   (a) The auditing department?
   (b) A coupon department segregated from the tellers' and accounting department?
7. Is the auditing department or an individual without access to cash or securities responsible for listing securities purchased per the cash book and ascertaining that they are properly deposited in the vault?
8. When exchanges of bonds are made is it required that a member of the auditing department examine the bonds received in exchange, ascertain that they are canceled, and perforate them with a distinctive punch before delivery of the new bonds?
9. Does the auditing department make daily proof of bonds, etc., deposited against certificates of deposit or under escrow agreements, etc.?
10. Does the officer signing as registrar or transfer agent mark the certificates transferred to avoid their subsequent use?

SAVINGS AND TIME DEPOSITS

1. Are deposits and withdrawals entered in passbook by machine with locked audit control?
2. If passbook and ledger card are not posted simultaneously are cards inaccessible to tellers?
3. Does auditing department control stock of unissued passbooks and make surprise examinations of unissued passbooks held by those authorized to issue them for the purpose of ascertaining that ledger cards have been properly opened?

4. Are large withdrawals investigated by the auditing department?
5. When accounts are closed:
   (a) Are passbooks obtained from depositors?
   (b) Is a letter written to depositor?
6. What steps are taken to prevent improper withdrawals by employees?

SAFE DEPOSIT DEPARTMENT

1. Are the following records maintained:
   (a) Contract with the renter?
   (b) Ledger card?

   Has proper routine been established for:
   (a) Issuance of receipts for rentals?
   (b) Positive identification of persons before permitting access to the box?
   (c) Complete record of all visits to the box giving the date, time and signature of the visitor?
   (d) The control of spare keys?
   (e) Control of keys on unrented boxes?
2. Does someone besides the attendant have a complete inventory of all rentable boxes in the vault?
3. If so, does the auditor or someone designated for the purpose make periodic checks of rentals and vacancies?
4. Are bills for rentals prepared by:
   (a) Vault attendant?
   (b) Bookkeeping department?
5. Do renters pay the amounts of the bills to someone other than the vault attendant?
6. Are prenumbered receipts issued for all rentals?
7. Does the vault attendant prepare periodically a list of boxes rented and surrendered and give such list to the auditor?
8. Is a list prepared of renters who are delinquent in paying their rental charge?
9. Is such list given to an officer at frequent intervals?

FOREIGN DEPARTMENT

1. Are tellers' settlement and departmental proof sheets prepared daily showing all transactions of the department? (The daily statement should be prepared based on the general ledger accounts of the de-

partment and should be set up in a manner to show both the "spot" position and the "future" position of the department.)

2. Is the daily statement submitted to an officer for review and initialed by him?
3. Has a policy been established to limit long and short transactions, and provisions made for approval of a senior officer when such limits are exceeded?
4. Is the function of receiving cash in payment for foreign exchange segregated from the function of drawing the drafts?
5. Does the auditing department review the rates charged?
6. Does the auditing department control the transactions by:
   (a) Use of prenumbered bookkeeping tickets?
   (b) Use of stub retained by signer of check and collected by auditing department?

INVESTMENT COMPANIES

PETTY CASH FUNDS

1. Is the imprest fund system used?
2. Is responsibility for each fund vested in only one person?
3. Is the custodian independent of the cashier or other employees who handle remittances from customers and other receipts?
4. Are the accounting records inaccessible to the custodian?
5. Does the custodian obtain a former voucher for all disbursements made from the fund?
6. Are such vouchers executed in ink or otherwise in such manner as to make alterations difficult?
7. Are the amounts of such vouchers spelled as well as written in numerals?
8. Are the vouchers approved by a department head or some equivalent employee?
9. Are checks for reimbursement made out to the order of the custodian?
10. Are reimbursement vouchers and attachments canceled at, or immediately following the signing of the reimbursing check, so that they cannot be misused thereafter?
11. Are funds audited by frequent and surprise counts by an internal auditor or other independent person?
12. If imprest fund is represented in whole or in part by bank account, has bank been notified that no checks payable to the company should be accepted for deposit?
13. Are petty cash funds restricted as to:
    (a) Amount not exceeding requirements for disbursements for a period of two weeks or less, and
    (b) Expenditures of a petty nature not exceeding a certain fixed amount?

20. Does control over cashed checks appear adequate?
21. Is there an adequate internal audit of reimbursement vouchers and attachments before reimbursement is made?

CASH RECEIPTS

1. Is the mail opened by someone other than cashier or bookkeeper?
2. Is a record prepared by the person opening the mail of the money and checks received, and is this record given to someone other than the cashier for independent verification of the details of the amount recorded and deposited? (See Question 6.)
3. Are each day's receipts deposited intact and without delay?
4. Does someone other than cashier make the bank deposit?
5. Are the duties of the cashier and the person making deposits divorced from:
   (a) Ledgers?
   (b) Expense records?
   (c) Dividend records?
   (d) Dividend payments?
   (e) Unclaimed dividend checks?
6. Is a duplicate deposit ticket, after authentication by the bank, received by an employee independent of the cashier and of the person who makes the deposits? Are such authenticated deposit tickets compared with the cash book?
7. Are deposits or collection items subsequently charged back by bank (because of insufficient funds, etc.) delivered directly to an employee other than the cashier?
8. Are negotiable assets, other than currency, checks or drafts in custody of an employee independent of cashier?
9. Is the cashier responsible for cash receipts from the time they are received in his office until they are deposited in the bank?
10. Are all bank accounts authorized by Board of Directors?

CASH DISBURSEMENTS

1. Are checks prenumbered?
2. Are voided checks kept and filed?
3. Is the sequence of check numbers accounted for by whoever reconciles bank balances?
4. Is a check protector used?
5. Is a check register prepared simultaneously with the preparation of the check by mechanical device?

6. Are authorized signatures limited to employees who have no access to:
   (a) Accounting records?
   (b) Cash receipts?
   (c) Petty cash funds?
7. Is the signing or countersigning of checks in advance prohibited?
8. Is the practice of drawing checks to "CASH" prohibited?
9. Are transfers from one bank to another under accounting control?
10. Are bank reconciliations made by someone who had nothing to do with the cash procedures, including the signing of checks?
11. Does that employee (in Question 10) obtain the bank statements directly from the banks?
12. Is the practice of examining paid checks for date, name, cancellations, and endorsements followed by those reconciling bank accounts?
13. Does supporting data accompany checks when they are submitted for signature?
20. Where a mechanical check signer is used, is the signature die under adequate control?
21. Are vouchers and supporting data effectively canceled to prevent subsequent misuse?

CASH WITH CUSTODIAN OR TRUSTEE

1. Are requisitions or orders for cash disbursements signed by at least two officers?
2. Are such requisitions or orders accompanied by supporting bills:
   (a) When approved by officers?
   (b) When submitted to custodian or trustee?
3. Does the agreement with the custodian or trustee limit disbursements to:
   (a) Payment for security purchases against delivery of stock upon orders approved by authorized officials?
   (b) Payment of expenses only upon orders approved by authorized officials?
   (c) Payment only of specified expenses?
4. Is all cash received directly by custodian or trustee?

CUSTODY OF SECURITIES

I—In Company's vault or safe deposit box

1. Can access be had only jointly by at least two employees, one of which is an officer?
2. Do company's procedures provide that each authorized person visiting the vault or safe deposit box:
   (a) Count securities which are deposited in and withdrawn from vault or safe deposit box?
   (b) Remain in attendance at all times when vault or safe deposit box is open?
3. Are withdrawals made only on the basis of written authorizations?
4. If answer to Question 3 is "yes":
   (a) Does such authorization state the purpose of the withdrawal (i.e., sale, transfer, etc.)?
   (b) Are authorizations approved by an officer or responsible employee whose duties are independent of record keeping?
5. Is a written record maintained in respect of securities deposited in and withdrawn from vault or safe deposit box?
6. Is the record mentioned in Question 5 checked by an employee not having access to securities with:
   (a) Accounting records?
   (b) Authorizations mentioned in Question 3?
7. Is responsibility for any securities in office placed in one employee who does not have access to accounting records?
8. Does the company comply with all provisions regarding custody of securities which are contained in its insurance policies?
9. Are bonds periodically inspected by employees, other than those having access to securities, to see that interest coupons and attached warrants are intact?
10. Are records maintained showing certificate numbers of securities owned?
11. Is the depositary either a bank or trust company?

II—With bank as custodian or trustee

1. Are deposits and withdrawals of securities made only on the basis of requisitions or orders signed by at least two officers?

2. Does agreement with custodian or trustee restrict the delivery of securities except upon receipt of proceeds of sale?
3. Are payments for purchases and proceeds from sales of securities paid or received directly by the custodian or trustee?
4. Is custodian or trustee either a bank or a trust company?

INVESTMENTS

1. Are all securities (including treasury stock), other than those due from brokers on current trades, held in the company's vault or under a custodian arrangement with a bank or trust company?
2. Are securities presently considered to be "worthless" or of nominal value, but which may have potential value, under accounting control?
3. Are securities mentioned in Question 2 periodically checked against available statistical data to ascertain whether or not they have become of any value?
4. Are the computations of profit and loss on sales of securities rechecked by another employee as to:
   (a) Profits and losses for corporate accounting purposes?
   (b) Profits and losses for tax purposes?
5. Are purchases and sales of securities authorized by the Board of Directors:
   (a) Before transactions are executed?
   (b) Periodically after transactions are executed?
   (c) As to prices which are to be paid or received?
6. Are purchases and sales confirmations received from brokers checked with orders transmitted to brokers?
7. Are recorded purchases and sales of securities checked with authorizations of the Board of Directors?
8. Are prices, extensions, commissions, taxes, etc., on purchases and sales of securities checked by an employee in the accounting department?
9. Are all securities owned (other than bearer certificates) registered in the name of the company?
10. Is it feasible to identify specific certificates delivered against sales?
11. If the answer to Question 10 is "yes," is the "identification" method used for tax purposes to preclude possible adjustments by Treasury Department of reported capital gains and losses?

20. Where the tax basis of securities differs from the accounting basis are tax records maintained in a manner to enable the accurate determination of costs on a tax basis?

NOTES PAYABLE

1. Are borrowings authorized by Board of Directors?
2. Are the banks from which funds may be borrowed specifically mentioned in the minutes?
3. Are the officers empowered to borrow specifically named in the minutes?

CAPITAL STOCK, ETC.

1. Does client employ independent registrar and transfer agents?
2. If not:
   (a) Are unissued certificates and stock certificate stubs in custody of an officer?
   (b) Are surrendered certificates effectively canceled?
3. Does the client employ independent dividend paying agents?

20. If answer to Question 3 is "no," is proper control apparently exercised in preparing, mailing, and accounting for unclaimed dividend checks?

ISSUANCES AND REDEMPTIONS OF CAPITAL STOCK
(for "open-end" companies)

I—Computation of offering and redemption price.

1. Are market prices used checked against a second source?
2. Are all extensions, footings, and calculations checked by a second employee?
3. Are share holdings, as shown in "price make-up" sheets, checked daily against security ledgers?
4. Is provision made for daily accrual of income and expenses?
5. Are amounts used in "price make-up" sheets checked against the company's accounting records daily?
6. Where price changes during the day are computed by application of an over-all percentage factor (e.g., change in Dow Jones averages), does the company periodically test the ac-

curacy of this factor by comparison with a detailed computation?

II—General.

1. Are orders for purchase and sale of capital stock "time-stamped" and promptly recorded in books or reported to custodian or trustee?
2. Is a record kept showing the amount of unsold shares under the company's currently effective registration statement?
3. Are payments made only upon receipt of treasury shares and shares issued only upon receipt of payment therefor?
4. Do the records include approval by officers or directors of:
   (a) Each price for company shares as computed?
   (b) Number of shares sold and repurchased at each price?
5. Are receipts for sales of shares and payments for repurchases under control of the custodian?

20. Does the company appear to have an adequate follow-up system to see that it complies with the "Blue Sky" laws of the various states in which its capital stock is sold?

DIVIDEND AND INTEREST INCOME

1. Are securities owned registered in the name of the company, its nominee, or its custodian's nominee?
2. Are announcements of dividends in published sources (i.e., Standard Statistics or Fitch) checked against the company's holdings and a written record made thereof?
3. Is a recheck of announcements made by a second employee?
4. Are dividends recorded promptly on the "ex-dividend" dates?
5. Are procedures designed to safeguard against the possibility of not recording dividends on stocks bought between the declaration date and record date?
6. Where information as to dividends declared by unlisted companies is not obtainable from dividend services, does the company correspond periodically with such companies to ascertain whether or not dividends have been declared?
7. Are all dividends received during a taxable year checked to see whether or not, from a tax viewpoint, they should be considered wholly or partly a return of capital?
8. Are accruals of interest income periodically recorded by an employee who has no access to securities?

9. Are available statistical reports referred to periodically to ascertain whether interest payments have been resumed in full or in part with respect to:
   (a) Bonds held, upon which interest is in default?
   (b) "Income" bonds held upon which interest is dependent on earnings?

EXPENSES

1. Are payments of expenses approved by an authorized officer or employee?
2. Is there an employee responsible for checking the arithmetical accuracy (as respects computations of charges against agreed rates) of bills for transfer agents', registrars', dividend-paying agents' and custodians' fees?
3. Do bills or vouchers bear evidence of approval and of the verification mentioned in Question 2?

PAY ROLLS

1. Are all changes in rates, additions, and dismissals authorized?
2. Are employees paid by check?
3. If answer to Question 2 is "yes," are the checks prenumbered?
4. Are pay roll checks signed by employees who do not participate in:
   (a) The preparation of the pay roll?
   (b) Custodianship of cash funds?
   (c) Maintenance of accounting records?
5. Are pay roll disbursements made from an imprest bank account restricted to that purpose?
6. Are reconciliations of pay roll bank accounts made by employees whose duties are unrelated to the pay roll?
7. Does procedure followed when reconciling pay roll bank accounts include the checking of names on pay roll checks against pay roll records and the examination of endorsements on checks?
8. Are officers' salaries approved by the Board of Directors?

GENERAL

1. Are employees' duties rotated?
2. Are all employees required to take vacations?

3. Are all employees in positions of trust bonded?
4. Are the amounts of the fidelity bonds, as listed in our working papers, apparently adequate?
5. Are known relatives so employed as to make collusion improbable?
6. Are the books of account apparently:
   (a) Adequate for the business?
   (b) Kept up to date?
   (c) Balanced at least monthly?
7. Do internal reports to the management appear to be adequate to bring to light abnormal financial figures and other discrepancies?
8. Does some responsible employee periodically review insurance coverage?
9. Are journal vouchers approved by a responsible employee?
10. Are journal vouchers or entries in journal adequately explained or supported by substantiating data?
11. Does company obtain information to determine whether officials are unaffiliated with other business enterprises with which it does business?
12. Are all bank accounts in the name of the corporation or its agents recorded on the books?
13. If company is a "mutual investment company" or a "diversified company" are procedures in effect to prevent the management from unwittingly disqualifying the company under the respective provisions of the Internal Revenue Code or the Investment Company Act of 1940?
14. Does it appear that persons responsible for approval of transactions (expenses, security transactions, etc.) are familiar with the operations of the company to an extent which makes such approval an effective control?

STOCK BROKERAGE FIRMS

PETTY CASH FUNDS

1. Is the imprest fund system used?
2. Is responsibility for each fund vested in one person?
3. Does someone other than the custodian handle remittances from customers and other receipts?
4. Are the duties of the custodian divorced from the customers' and general ledgers?
5. Does the custodian obtain a formal voucher for all disbursements made from the fund?
6. Are such vouchers executed in ink or otherwise in such manner as to make alterations difficult?
7. Are the amounts of such vouchers spelled as well as written in numerals?
8. Are the vouchers approved by a partner, manager or some other designated responsible employee?
9. Are checks for reimbursement made out to the order of the custodian?
10. Are reimbursement vouchers and attachments canceled at, or immediately following the signing of the reimbursing check, so that they cannot be misused thereafter?
11. Are funds audited by frequent and surprise counts by an internal auditor or other independent person?
12. If imprest fund is represented in whole or in part by bank accounts, has bank been notified that no checks payable to the company should be accepted for deposit?
13. Are petty cash funds restricted as to:
    (a) Amount not exceeding requirements for disbursements for a period of two weeks or less, and
    (b) Expenditures of a petty nature not exceeding a certain fixed amount?

20. Does control over cashed checks appear adequate?
21. Is there an adequate internal audit of reimbursement vouchers and attachments before reimbursement is made?

CASH RECEIPTS

1. Is the mail opened by someone other than any member of cashier's, bookkeeping, and margin departments?
2. Is a record prepared by the person opening the mail of the money and checks received, and is this record given to someone other than the cashier for independent verification of the amount recorded and deposited? (See Question 5a.)
3. Are each day's receipts deposited intact and without delay?
4. Are the duties of the person making the bank deposit divorced from the cashier's, margin, accounting, and bookkeeping departments?
5. Is a duplicate deposit ticket, after authentication by the bank, received by an employee independent of the cashier and of the person who makes the deposits?

   Are such authenticated deposit tickets compared with:
   - (a) Record of incoming remittances?
   - (b) The cash book?
6. Are deposits or collection items subsequently charged back by bank (because of insufficient funds, etc.) delivered directly to an employee other than one in the cashier's department?
7. Is the cashier responsible for cash receipts from the time they are received in his office until they are deposited in the bank?
8. Are all bank accounts authorized by a partner?
9. Where branch office bank accounts are maintained, are such accounts controlled by:
   - (a) Separate books of account at the branch office, or
   - (b) The main office?
10. If the branch office bank accounts are controlled by the main office:
    - (a) Are the cash transactions of the branch office reported daily to the main office?
    - (b) Are the reconciliations of these bank accounts made by a responsible employee at the main office?
    - (c) If so, are the monthly statements and paid checks sent directly to the main office by the respective banks?
    - (d) Are the cash transactions of the branch office reviewed carefully by a partner or a responsible employee of the main office?
11. Are the cashier's duties divorced from:
    - (a) Customers' ledgers?
    - (b) Preparation or mailing of customers' statements?

(c) Margin records?
(d) Security (long and short) records?

20. Is the receipt of currency, as opposed to checks or drafts, relatively insignificant?

21. If the branch office bank accounts are controlled by separate books of account at the branch office, is that office under the close supervision of a partner and does it have a personnel of a sufficient number to obtain adequate internal control?

CASH DISBURSEMENTS

1. Are checks prenumbered?

2. Are voided checks kept and filed?

3. Is the sequence of check numbers accounted for by whoever reconciles bank balances?

4. Is a check protector used?

5. Is a check register prepared simultaneously with the preparation of the check by mechanical device?

6. Are authorized signatures limited to employees who have no duties in connection with:
   (a) Accounting records?
   (b) Cash receipts?
   (c) Petty cash funds?

7. Is the signing or countersigning of checks in advance prohibited?

8. Is the practice of drawing checks to "CASH" or "BEARER" prohibited?

9. Are transfers from one bank to another under accounting control?

10. Are bank reconciliations made by someone who had nothing to do with the cash procedures, including the signing of checks?

11. Does that employee (in Question 10) obtain the bank statements directly from the banks?

12. Is the practice of examining paid checks for date, name, cancellations, and endorsements followed by those reconciling bank accounts?

13. Do supporting data accompany checks when they are submitted for signature? (See Customers' Accounts, Question 6, and Expenses.)

20. Where a mechanical check signer is used, is the signature die under adequate control?

21. Are vouchers and supporting data effectively canceled to prevent subsequent misuse?

SECURITIES

1. Does the firm comply with all provisions regarding custody of securities which are contained in its insurance policies?

2. When securities are in the "Cage," is:
   (a) The door always kept locked?
   (b) Someone in attendance at all times?

3. Is responsibility for handling securities placed in persons who have no duties in connection with accounting records?

4. Are customers' securities "received" and "delivered" only upon written instructions?

5. Do blotters show certificate numbers of securities received and delivered?

6. Are receipts required for all securities delivered "free"? If so:
   (a) Are such receipt forms prenumbered?
   (b) Is there a definite responsibility for follow up and the obtaining of receipts by someone outside the cashier's department?

7. Before placing securities in "box" or safekeeping, are:
   (a) The certificates double checked as to their negotiability?
   (b) Bonds inspected for coupons and warrants?

8. Are securities in box counted periodically and checked to stock and bond records?

9. Is there any indication on stock and bond records to show for whom safekeeping and excess margin securities have been segregated?

10. If answer to Question 9 is "yes":
    (a) Are the segregated securities (safekeeping and excess margin) counted periodically and checked as to customer names and amounts, to stock and bond records?
    (b) Are such counts made by persons other than "Cage" employees?
    (c) Are the segregated securities (safekeeping and excess margin) shown by the margin cards checked periodically, as to customer names and amounts, to stock and bond records? (See Question 3 under Margin Department.)

11. If answer to Question 9 is "no":
    (a) Are such segregated securities counted periodically and checked, as to customer names and amounts, to "safe-

keeping" record in the "Cage" and also, in total, to stock and bond records?

(b) Are securities counted by persons other than "Cage" employees?

(c) Are the segregated securities, shown by the margin cards, checked periodically to "safekeeping" record in the "Cage"? (See Question 3 under Margin Department.)

12. Is the client's registered nominee (for the purposes of stock certificates):

(a) A member of firm?

(b) A responsible employee?

CUSTOMERS' ACCOUNTS

1. Are monthly statements sent to all customers who have transactions during the month?

2. Are statements sent to *all* customers periodically regardless of whether or not there were transactions during the period?

3. Before mailing statements are the securities, shown long and short thereon, checked to:

(a) Stock and bond records?

(b) Margin records? (See Question 2 under Margin Department.)

4. Are adjustments for disputed items approved by a partner or manager?

5. Are write-offs of bad debts and adjustment credits approved by a partner or manager?

6. Is written approval of any member of margin department a prerequisite to payment of funds from customers' accounts?

7. Is written approval of any member of margin department a prerequisite to delivery of securities out of customers' accounts?

8. Are customer accounts regularly balanced with control?

9. Are the calculations of interest charged or credited to customers' accounts checked by someone other than the one who makes original computations?

10. Are the bookkeepers instructed to notice when posting the dividend credit and charge entries that the customer is, or has been, long or short of the stock?

11. Are customers' statements and ledger postings made simultaneously by means of a bookkeeping device?

12. If there is more than one customers' ledger bookkeeper are the account sections for which each bookkeeper is responsible alternated from time to time?

13. Are the duties of the bookkeepers of the general and customers' accounts separate from:
    (a) Cash functions?
    (b) Margin department functions?

14. Are service and investment advisory charges reviewed and approved by a partner or a responsible employee?

15. Does the client decline to handle "discretionary" accounts?

16. Are coupon and dividend collections on securities in the client's custody credited to the customers' accounts even where immediate payment is made to the customer?

17. Are profits and losses in the customers' commodity accounts (open positions) periodically proved with the contract difference account?

20. Is proper control exercised over bad debts after they have been written off?

FIRM INVESTMENT AND TRADING ACCOUNTS

1. Are purchases and sales of securities for firm account authorized by:
    (a) A partner?
    (b) Manager or other responsible employee?

2. Are computations of profits and losses on sales of securities rechecked by another employee?

3. Are securities presently considered to be "worthless" or of nominal value, but which may have potential value, under accounting control?

4. Are securities mentioned in Question 3 periodically checked against available statistical data to ascertain whether or not they have become of any value?

5. Are prices, extensions, commissions, taxes, etc., on purchases and sales of securities checked by an employee in the accounting department?

6. Are profits on underwritings, selling commissions, etc., checked with underwriting and selling agreements?

7. Are lists of firm securities periodically prepared and reviewed by the partners?

8. Is the income (interest and dividends) on securities in firm accounts checked at frequent intervals by someone other than the dividend clerk?

MARGIN DEPARTMENT

1. Are authorizations by a partner or manager required before a customer's account is opened for:
   (a) Margin accounts?
   (b) Cash accounts?
2. Are margin department records compared monthly with security positions and ledger balances shown on customers' statements?
3. Are margin department records of segregated securities (safekeeping and excess margin) checked to:
   (a) Records of segregated securities kept in the cashier's department, or
   (b) Physical counts of segregated securities?
4. Are daily reports of undermargined or deficit accounts submitted to a partner or manager?
5. If there is more than one margin clerk are the accounts for which each margin clerk is responsible alternated from time to time?
6. Are the duties of the margin clerks separated from the functions of the:
   (a) Cashier's department?
   (b) Bookkeeping department?
7. Are the computations on the margin records test-checked at frequent intervals by an internal auditor or a person whose duties are independent of the margin department to determine that the minimum margin requirements of the firm are being maintained?

DIVIDENDS AND BOND INTEREST

1. Are the duties of the person who handles dividends and bond interest and their distribution to customers' and firm accounts divorced from the handling or recording of cash transactions and the recording of transactions in the general and customers' ledgers?
2. Are all dividend and bond interest transactions cleared through the dividend and coupon accounts?
3. Are claims or due bills obtained in support of payments for dividends or securities registered in the firm's name but held by others?

4. If so, are such claims or due bills approved by someone other than the dividend clerk?
5. Are unclaimed dividends regularly balanced with control?
6. Are all charges to unclaimed dividend and interest accounts approved before payment by a partner, manager or other responsible employee (not connected with dividend and bond interest accounting function)?

20. Are procedures and routines designed to safeguard against dividends being overlooked or credited to accounts other than those for which intended?

EXPENSES

1. Are the computations of floor brokerage charges checked by another employee?
2. Is an adequate record maintained for such amounts due each broker?
3. Are monthly bills from other brokers checked to above record before payment?
4. Is interest on money borrowed checked before it is paid?
5. Is responsibility for incurring expenses, purchase of supplies, etc., centralized?
6. Is there a definite (supported by evidence) responsibility for checking invoices as to:
   (a) Prices?
   (b) Extensions?
   (c) Receipt of materials (office supplies, stationery, etc.)?
7. Are payments of expenses approved by a partner or authorized employee?
8. Are invoices and expense reports adequately canceled to avoid subsequent misuse?
9. Are expense distributions established by responsible employees?
10. Is postage metered?
11. If the branch office expenses are not controlled through separate accounts maintained at the branch office, are such expenses carefully reviewed by a partner or responsible employee at the main office?
12. Are the entries in the "error account":
    (a) Properly explained?
    (b) Approved by a partner?

PAY ROLLS

1. Is the preparation of pay roll performed by someone who is divorced from cashiers' and accounting departments?
2. Are clerical operations in preparation of pay rolls double checked before payment?
3. Is time record made on time-clocks?
4. Are all changes in rates, additions and dismissals evidenced by proper written authorizations?
5. Are employees paid by:
   (a) Check?
   (b) Cash?
6. If answer to Question 5(a) is "yes," are the checks prenumbered?
7. If answer to Question 5(b) is "yes," are receipts obtained from employees?
8. Are pay roll checks signed by employees who do not participate in:
   (a) The preparation of the pay roll?
   (b) Custodianship of cash funds?
   (c) Maintenance of accounting records?
9. Are pay roll disbursements made from an imprest bank account restricted to that purpose?
10. Are reconciliations of pay roll bank accounts made by employees whose duties are unrelated to the pay roll department?
11. Does procedure followed when reconciling pay roll bank accounts include the checking of names on pay roll checks against pay roll records and the examination of endorsements on checks?
12. Are salary rolls and special pay roll items (i.e., advances, etc.) subjected to the same critical routine as regular payments?
20. Is proper control exercised over back pay and unclaimed salaries, if any?

GENERAL AND SUNDRY

1. Is the accounting department's function completely divorced from:
   (a) Purchases and sales of securities?
   (b) Cash receipts and disbursements?
   (c) Handling of securities?
   (d) Handling of dividends and interest?

2. Are prices, extensions, commissions, taxes, etc., on purchases and sales of securities double checked?
3. Are revenue stamps under control of someone outside of the purchases and sales department and the accounting department?
4. Are "Street" items, bank loans (including collateral) and items in transfer confirmed periodically?
5. Are bank loans authorized by partner or an authorized employee?
6. Are the computations of floor brokerage receivable checked by another employee?
7. Is an adequate record maintained for floor brokerage due from each broker?
8. Are monthly bills to brokers checked to records (in Question 7) before mailing?
9. Are employees' duties rotated in:
   (a) Bookkeeping department?
   (b) Margin department?
10. Are all employees required to take vacations?
11. Are all employees bonded?
12. Are the amounts of the fidelity bonds, as listed in our working papers, apparently adequate?
13. Does some responsible employee periodically review insurance coverage?
14. (a) Are known relatives employed?
    (b) If so, is their assignment of duties such as to make collusion impossible?
15. Are journal vouchers or, in absence of journal vouchers, the entries in the journal approved by a partner or a responsible employee?
16. Are journal vouchers or entries in journal adequately explained or supported by substantiating data?
17. Does accounting control exercised over branch operations appear to be adequate?
18. Does the client have an internal auditor?
19. If so, do we review the program of the internal auditor and his reports?
20. Do internal reports to the management appear to be adequate to bring to light any abnormal financial figures and other discrepancies?
21. Are there any bank accounts in the name of the firm or employees' associations which are not recorded on the books?

22. Are the books of account apparently:
    (a) Adequate for the business?
    (b) Kept up to date?
    (c) Balanced at least monthly?

23. Are employees' duties reasonably fixed as to responsibility?

INDEX

A

D

E

G

S

T

U

V

W